DOCKET

SUPREME COURT
OF THE UNITED STATES

No. 12-562
Title: United States, Petitioner
v.
Gary Woods, as Tax Matters Partner of Tesoro Drive Partners and SA Tesoro Investment Partners
Docketed: November 6, 2012
Lower Ct: United States Court of Appeals for the Fifth Circuit
Case Nos.: (11-50487)
Decision Date: June 6, 2012
Rehearing Denied: August 8, 2012
Questions Presented

~~Date~~~	~~~~~~~Proceedings and Orders~~~~~~~~~~~~~~~~~~~~
Nov 6 2012	Petition for a writ of certiorari filed. (Response due December 6, 2012)
Dec 19 2012	DISTRIBUTED for Conference of January 11, 2013.
Jan 4 2013	Response Requested . (Due February 4, 2013)
Feb 4 2013	Brief of respondents Gary Woods, as Tax Matters Partner of Tesoro Drive Partners, et al. in opposition filed.
Feb 20 2013	DISTRIBUTED for Conference of March 15, 2013.
Feb 20 2013	Reply of petitioner United States filed. (Distributed)
Mar 18 2013	DISTRIBUTED for Conference of March 22, 2013.
Mar 25 2013	Petition GRANTED. In addition to the question presented by the petition, the parties are directed to brief and argue the following question: Whether the district court had jurisdiction in this case under 26 U. S. C. 6226 to consider the substantial valuation misstatement penalty.
Apr 4 2013	The time to file the joint appendix and petitioner's brief on the merits is extended to and including May 30, 2013.
Apr 4 2013	The time to file respondents' brief on the merits is extended to and including July 22, 2013.
May 30 2013	Joint appendix filed. (Statement of costs filed.)
May 30 2013	Brief of petitioner United States filed.
Jun 5 2013	Brief amicus curiae of Professor Amandeep S. Grewal in support of neither party filed.
Jul 19 2013	Brief of respondents Gary Woods, as Tax Matters Partner of Tesoro Drive Partners, et al. filed. (Distributed)
Jul 22 2013	CIRCULATED.
Jul 23 2013	SET FOR ARGUMENT on Wednesday, October 9, 2013.

Jul 25 2013	Brief amicus curiae of Professor David J. Shakow filed. (Distributed)
Jul 26 2013	Brief amici curiae of Gordon W. Bush, et al. filed. (Distributed)
Jul 26 2013	Brief amici curiae of New Millennium Trading, LLC, et al. filed. (Distributed)
Jul 26 2013	Brief amici curiae of Scott and Audrey Blum filed. (Distributed)
Jul 26 2013	Brief amicus curiae of Partners in Jade Trading, LLC, et al. filed. VIDED. (Distributed)
Aug 2 2013	Record received from U.S.C.A. for 5th Circuit is electronic.
Aug 2 2013	Record received from U.S.D.C. for Western District of Texas is electronic.
Aug 19 2013	Reply of petitioner United States filed. (Distributed)
Oct 8 2013	Letter and attachments dated October 7, 2013 received from counsel for respondents. (Distributed)
Oct 9 2013	Argued. For petitioner: Malcolm L. Stewart, Deputy Solicitor General, Department of Justice, Washington, D. C. For respondents: Gregory G. Garre, Washington, D. C.
Oct 28 2013	Exhibits received from the U.S.D.C. for the Western District of Texas San Antonio Division. (Three boxes)

PETITION FOR WRIT OF CERTIORARI

FILED
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12-562

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In the Supreme Court of the United States

UNITED STATES OF AMERICA, PETITIONER

v.

GARY WOODS, AS TAX MATTERS PARTNER OF TESORO DRIVE PARTNERS AND SA TESORO INVESTMENT PARTNERS

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

PETITION FOR A WRIT OF CERTIORARI

DONALD B. VERRILLI, JR.
Solicitor General
Counsel of Record
KATHRYN KENEALLY
Assistant Attorney General
MALCOLM L. STEWART
Deputy Solicitor General
JOHN F. BASH
Assistant to the Solicitor General
GILBERT S. ROTHENBERG
RICHARD FARBER
ARTHUR T. CATTERALL
Attorneys
Department of Justice
Washington, D.C. 20530-0001
SupremeCtBriefs@usdoj.gov
(202) 514-2217

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QUESTION PRESENTED

Section 6662 of the Internal Revenue Code prescribes a penalty for an underpayment of federal income tax that is "attributable to" an overstatement of basis in property. 26 U.S.C. 6662(a), (b)(3), (e)(1)(A) and (h)(1). The question presented is as follows:

Whether the overstatement penalty applies to an underpayment resulting from a determination that a transaction lacks economic substance because the sole purpose of the transaction was to generate a tax loss by artificially inflating the taxpayer's basis in property.

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GARY WOODS, AS TAX MATTERS PARTNER OF TESORO DRIVE PARTNERS AND SA TESORO INVESTMENT PARTNERS

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

PETITION FOR A WRIT OF CERTIORARI

The Solicitor General, on behalf of the United States of America, respectfully petitions for a writ of certiorari to review the judgment of the United States Court of Appeals for the Fifth Circuit in this case.

OPINIONS BELOW

The opinion of the court of appeals (App., *infra*, 1a-2a) is reported at 471 Fed. Appx. 320. The opinions of the district court (App., *infra*, 3a-14a, 15a-22a) are reported at 794 F. Supp. 2d 714 and 794 F. Supp. 2d 710.

JURISDICTION

The judgment of the court of appeals was entered on June 6, 2012. A petition for rehearing was denied on August 8, 2012 (App., *infra*, 23a-24a). The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATUTORY AND REGULATORY PROVISIONS INVOLVED

The pertinent statutory and regulatory provisions are reprinted in the appendix to this petition. App., *infra*, 25a-45a.

STATEMENT

This case raises an important question for the administration of the federal tax laws that has long divided the circuits. Section 6662 of the Internal Revenue Code imposes a penalty for an underpayment of income tax that is "attributable to" an overstatement of the value or basis of property. 26 U.S.C. 6662(a), (b)(3), (e)(1)(A) and (h)(1).[1] The Fifth Circuit has held that the penalty does not apply to situations where the IRS concludes that a transaction is a sham lacking economic substance and therefore treats it as a nullity in calculating a participant's tax liability, even if the taxpayer has claimed an unjustified tax benefit by artificially inflating the value or basis of property. As three members of the Fifth Circuit have acknowledged, there is "near-unanimous opposition" to that position among the other courts of appeals, with only the Ninth Circuit adopting the Fifth Circuit's approach. *Bemont Invs., L.L.C.* v. *United States*, 679 F.3d 339, 354 (5th Cir. 2012) (Prado, J., concurring, joined by Reavley and Davis, J.J.) (*Bemont Invs.*). Nevertheless, the Fifth Circuit has deemed the issue "well settled" in that circuit and has declined to reconsider its position. App., *infra*, 2a.

1. a. Our federal tax system, "relying as it does upon self-assessment and reporting," *United States* v. *Arthur*

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[1] Unless otherwise indicated, all citations to 26 U.S.C. 6662 are to that statute as it appears in the 2000 edition of the United States Code.

Young & Co., 465 U.S. 805, 815 (1984), prescribes various penalties for taxpayers who fail to report and pay all of the tax that they owe. As relevant here, the Internal Revenue Code imposes penalties if a taxpayer overstates the value of property, or the taxpayer's basis in property, on a tax return in a way that reduces the total taxes reported and paid. For example, a taxpayer might overstate the value of a painting donated to charity to obtain a larger charitable deduction. Likewise, a taxpayer might overstate her basis in shares of stock that she sold to make it appear that she realized a loss on the transaction.

To deter such overstatements, Section 6662 of the Code provides that "there shall be added to the [income] tax [owed] an amount equal to 20 percent of the portion of the underpayment * * * which is attributable to * * * [a]ny substantial valuation misstatement." 26 U.S.C. 6662(a) and (b)(3). A taxpayer commits a "substantial valuation misstatement" if, *inter alia*, "the value of any property (or the adjusted basis of any property) claimed on any [tax return] is 200 percent or more of the amount determined to be the correct amount of such valuation or adjusted basis (as the case may be)." 26 U.S.C. 6662(e)(1)(A). No penalty may be imposed, however, unless the underpayment exceeds $5000. 26 U.S.C. 6662(e)(2).

Section 6662 also establishes a greater penalty for a "gross valuation misstatement[]," defined to be an overstatement of the value or basis of property that is 400% or more of the correct amount. 26 U.S.C. 6662(h)(2)(A)(i).[2] "To the extent that a portion of the

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[2] Section 6662 was amended in 2006 to provide that the threshold for a "substantial valuation misstatement" is 150% (26 U.S.C. 6662(e)(1)(A)) and the threshold for a "gross valuation misstate-

underpayment [of income tax] is attributable to one or more gross valuation misstatements," a penalty equal to 40% of that portion of the underpayment is imposed on the taxpayer. 26 U.S.C. 6662(h)(1).

b. As the text of Section 6662 implicitly recognizes, cases may arise in which part of a taxpayer's underpayment of tax is "attributable to" an overstatement of value or basis, while the remainder of the underpayment is attributable to other errors (for example, failing to include all taxable income or taking an inapplicable deduction). In those circumstances, it is necessary to identify the "portion" of the underpayment of tax that is "attributable to" the overstatement in order to determine whether the overstatement penalty applies.

After the passage of the Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, 95 Stat. 172, which added the predecessor to the overstatement penalty of Section 6662,[3] the staff of Congress's Joint Committee on Taxation produced a summary of the legislation known as the

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ment[]" is 200% (26 U.S.C. 6662(h)(1)). See Pension Protection Act of 2006, Pub. L. No. 109-280, § 1219(a)(1) and (2), 120 Stat. 1083.

[3] The predecessor to the overstatement penalty of Section 6662 was located at 26 U.S.C. 6659 and provided a schedule of penalties for "an underpayment of [income tax] for the taxable year which is attributable to a valuation overstatement," defined to exist "if the value of any property, or the adjusted basis of any property, claimed on any return is 150 percent or more of the amount determined to be the correct amount of such valuation or adjusted basis." 26 U.S.C. 6659(a) and (c) (1988). Section 6662 replaced Section 6659 (and other penalty provisions) in 1989. See Improved Penalty Administration and Compliance Tax Act, Pub. L. No. 101-239, Tit. VII, Subtit. G, § 7721(a) and (c)(2), 103 Stat. 2395, 2399. The principal purpose of the change was to "improve the fairness, comprehensibility, and administrability of the[] penalties" by consolidating a number of penalty provisions in one section. H.R. Rep. No. 247, 101st Cong., 1st Sess. 1388 (1989).

Blue Book. See Staff of the Joint Comm. on Taxation, 97th Cong., *General Explanation of the Economic Recovery Tax Act of 1981* (Comm. Print 1981) (*Blue Book*). The *Blue Book* stated that "[t]he portion of a tax underpayment that is attributable to a valuation overstatement will be determined after taking into account any other proper adjustments to tax liability." *Id.* at 333. It then set forth a formula to calculate the appropriate portion:

> [T]he underpayment resulting from a valuation overstatement will be determined by comparing the taxpayer's (1) actual tax liability (i.e., the tax liability that results from a proper valuation and which takes into account any other proper adjustments) with (2) actual tax liability as reduced by taking into account the valuation overstatement. The difference between these two amounts will be the underpayment that is attributable to the valuation overstatement.

Ibid.[4] To illustrate the application of this formula, the *Blue Book* included the following example:

> Assume that in 1982 an individual files a joint return showing taxable income of $40,000 and tax liability of $9,195. Assume, further, that a $30,000 deduction which was claimed by the taxpayer as the result of a valuation overstatement is adjusted down to $10,000, and that another deduction of $20,000 is disallowed totally for reasons apart from the valuation overstatement. These adjustments result in correct taxable income of $80,000 and correct tax liability of $27,505. Accordingly, the underpayment due to the

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[4] An almost identical explanation appears in the legislative history of a similar penalty provision enacted in 1986. See H.R. Rep. No. 426, 99th Cong., 1st Sess. 763 (1985).

> valuation overstatement is the difference between the tax on $80,000 ($27,505) and the tax on $60,000 ($17,505) (i.e., actual tax liability reduced by taking into account the deductions disallowed because of the valuation overstatement), or $9,800.

Id. at 333 n.2.[5]

c. In 1991, the Treasury Department promulgated a regulation addressing various issues with respect to overstatement penalties under Section 6662. See 26 C.F.R. 1.6662-5. Subsection (g) of that regulation provides that where the correct value or basis of property is zero—and thus the overstatement percentage would technically be infinite or undefined—any overstatement is a gross valuation misstatement. 26 C.F.R. 1.6662-5(g). The regulation also clarifies that the $5000 minimum underpayment to trigger the penalties applies to both substantial and gross valuation misstatements. See 26 C.F.R. 1.6662-5(b).

2. In November 1999, respondent and another individual, Billy Joe "Red" McCombs, elected to participate in an abusive tax shelter called Current Options Bring Reward Alternatives, or COBRA. App., *infra*, 4a-5a & n.2. The purpose of COBRA is to generate a large paper loss that can offset real gains that the taxpayer realizes in a given tax year. *Id.* at 5a. McCombs, at one time the owner of the NBA's San Antonio Spurs and the NFL's Minnesota Vikings, expected to realize significant income in 1999 from the expansion of the NFL to include the resurrected Cleveland Browns franchise. *Id.* at 16a;

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[5] In what appears to have been an inadvertent error, the *Blue Book* example incorrectly calculated the underpayment attributable to the basis overstatement to be $9800 rather than $10,000 (*i.e.*, $27,505 minus $17,505).

9/15/2010 Trial Tr. (Afternoon Sess.) 76-77. Respondent Woods was a long-time business associate of McCombs. App., *infra*, 16a.

Like a number of other tax shelters that proliferated during the late 1990s and early 2000s, COBRA was designed to enable a taxpayer to claim an unlawful tax loss by artificially inflating her basis in a particular asset. When the asset is sold for far less than the asserted basis, the taxpayer claims a large loss on that sale that can be used to offset real gains from other transactions. App., *infra*, 5a.

To execute COBRA, a taxpayer purchases and sells largely offsetting short-term options on a foreign currency. See generally *RA Invs. I, LLC* v. *Deutsche Bank AG*, No. 3:04-cv-1565, 2005 WL 1356446, at *1 (N.D. Tex. June 6, 2005) (describing COBRA). For example, the taxpayer might purchase a 30-day option on a foreign currency valued at $100 million while selling a 30-day option on the same currency worth $95 million—for an out-of-pocket expenditure of $5 million. The taxpayer contributes both of those positions, plus a relatively small amount of cash (*e.g.*, $3 million), to a partnership established with another COBRA participant solely for the purpose of the transaction. The partnership then purchases a relatively small quantity of assets (say, $2 million worth of publicly traded stock or a foreign currency). When the offsetting options expire, the partnership is immediately dissolved and the assets are distributed to the partners. The taxpayer then sells the distributed assets, but claims a basis in them equal to the value of the purchased option plus the cash contributed to the dissolved partnership—in this example, $103 million, generating a $101 million artificial tax loss.

In order to achieve that large paper loss, the taxpayer includes the cost of the purchased option she contributed to the partnership in calculating her basis in her interest, but she does not reduce the basis by the amount of the nearly offsetting sold option. See App., *infra*, 19a. A (nonprecedential) Tax Court memorandum opinion from 1975 had held that, for purposes of the partnership basis rules, a sold option is a contingent liability—*i.e.*, a liability that a partner need not account for in determining her basis in the partnership. See *Helmer* v. *Commissioner*, 44 T.C.M. (P-H) ¶ 75,160, at 712 (1975).[6] Taxpayers who participated in COBRA exploited that opinion to generate an artificially high basis in the assets distributed by the sham partnership upon dissolution. In the example described above, the taxpayer claims on her tax return that her basis in the partnership—and therefore her basis in the assets distributed by the partnership at dissolution, see 26 U.S.C. 732(b)—is $103 million, even though she contributed only $8 million to the partnership (the $5 million difference between the prices of the offsetting options, plus the $3 million in cash).

Woods and McCombs together engaged in two COBRA transactions with two sham partnerships—one to generate ordinary losses and one to generate capital losses. App., *infra*, 5a-6a, 17a. After limited liability companies owned by Woods and McCombs contributed the requisite offsetting options, the partnerships purchased relatively small amounts of Canadian dollars and Sun Microsystems stock. *Id.* at 18a. When the partnerships dissolved and their assets were distributed to S corporations owned by Woods and McCombs, those

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[6] *Helmer* was superseded by regulations initially proposed in 2003. See 26 C.F.R. 1.752-1(a)(4)(ii).

assets were sold for small economic gains. See *id.* at 5a; Trial Exs. 252, 254. But by counting the cost of the purchased options as part of the bases in those assets, Woods and McCombs claimed huge losses on the 1999 returns of the S corporations (which were then allocated to the taxpayers individually). App., *infra*, 19a. Taking into account fees paid to other entities to participate in COBRA, Woods and McCombs together lost only $1.37 million on the transactions, but they reported more than $45 million in losses. See *ibid.*; 9/16/2010 Trial Tr. (Morning Sess.) 25-26.

3. The IRS disallowed the tax treatment of the COBRA transactions on various grounds, including that they lacked economic substance. Under the economic-substance doctrine, a longstanding common-law principle codified by Congress in 2010, "tax benefits * * * with respect to a transaction are not allowable if the transaction does not have economic substance or lacks a business purpose." 26 U.S.C. 7701(o)(5)(A) (Supp. V 2011). In this case, the IRS determined that each "purported partnership was formed and availed of solely for purposes of tax avoidance by artificially overstating basis in the partnership interests of its purported partners." Trial Ex. 198, at D0198.0032; Trial Ex. 199, at D0199.0032. The IRS further determined that "a 40 percent penalty shall be imposed on the portion of any underpayment attributable to the gross valuation misstatement[s]." Trial Ex. 198, at D0198.0034; Trial Ex. 199, at D0199.0034.

4. Respondent Woods, as Tax Matters Partner for the two partnerships, sued the United States to challenge both the IRS's conclusion that the COBRA transactions lacked economic substance and the applicability of the penalties imposed.

The district court upheld the IRS's determination that the transactions lacked economic substance. App., *infra*, 19a-21a. The "central theory of COBRA," the court explained, "was that the basis of each partnership's property was the cost of the 'long' currency options, while the 'short' options could be disregarded for tax purposes." *Id.* at 19a. The court further explained that the "use of two partnerships with a six-week life span to conduct that trading [was] for the sole purpose of generating a paper loss" via this artificially high basis. *Id.* at 20a. The court concluded that the COBRA transaction "was totally lacking in economic substance," and that "both the ordinary loss and the capital loss claimed by the respective partnerships should be disregarded for tax purposes." *Id.* at 21a.

In a subsequent opinion, however, the district court held that the overstatement penalty under Section 6662 was inapplicable. App., *infra*, 3a-14a. Citing the Fifth Circuit's decision in *Heasley* v. *Commissioner*, 902 F.2d 380 (1990), the court stated that "[i]n this Circuit * * * it is clearly established that whenever the Internal Revenue Service totally disallows a deduction, it may not penalize the taxpayer for a valuation overstatement included in that deduction." App., *infra*, 6a. It explained that "until and unless *Heasley* is overruled by the Court of Appeals or the Supreme Court, this Court is bound by its holding." *Ibid.*

5. While the government's appeal of the district court's penalty ruling was pending, the Fifth Circuit issued a decision in *Bemont Investments*, another case involving a tax shelter designed to "creat[e] an artificially high basis in partnership interests." 679 F.3d at 341. Relying on *Heasley*, *supra*, as well as the prior decision in *Todd* v. *Commissioner*, 862 F.2d 540 (5th Cir. 1988),

the court held that the overstatement penalty cannot apply when the IRS treats "transactions as a sham, and disallow[s] all tax attributes flowing from the transactions in full." *Bemont Invs.*, 679 F.3d at 347-348.

Judge Prado issued a concurring opinion, which was joined by the other two members of the panel. *Bemont Invs.*, 679 F.3d at 351. The concurring opinion explained that, although "a routine application of the *Todd/Heasley* rule decides this case," that "rule may be misguided." *Id.* at 351, 353. Judge Prado explained that "[a]rguably, if the *Todd/Heasley* rule did not bind us, tax underpayment in this case would be 'attributable to' a valuation overstatement." *Id.* at 353. The "basis misstatement and the transaction's lack of economic substance," Judge Prado reasoned, "are inextricably intertwined" because "[t]he basis misstatement was the engine of, the vehicle behind the sham transaction." *Id.* at 354. The concurrence further observed that "disregarding the deduction for a lack of economic substance pulls the correct basis to zero, which eliminates the claimed loss, and renders the tax underpaid." *Ibid.* As a result, "disregarding the transaction for a lack of economic substance does not alter the reality that the tax underpayment was ultimately 'attributable to' the basis misstatement—or so one could argue, in a world without *Todd/Heasley*." *Ibid.*

In his *Bemont Investments* concurrence, Judge Prado also noted "[t]he near-unanimous opposition to the *Todd/Heasley* rule" among other courts of appeals. 679 F.3d at 354. "Except for the Ninth Circuit," he explained, "every sister circuit that has considered the issue has concluded that the valuation misstatement penalty may apply even if the deduction is totally disallowed because the underlying transaction lacked economic

substance." *Ibid.* And although "the Ninth Circuit has not joined the majority because it is bound by its own precedent to follow the *Todd/Heasley* rule, it has questioned the rule's wisdom." *Id.* at 355 (citing *Keller* v. *Commissioner*, 556 F.3d 1056, 1060-1061 (9th Cir. 2009)).

Judge Prado further observed that "the *Todd/Heasley* rule could incentivize improper tax behavior" because it rewards taxpayers who do not merely misstate their basis in property but who "craft[] a more extreme scheme." *Bemont Invs.*, 679 F.3d at 355. As a result, "[a] taxpayer could generate an enormous improper tax benefit by overstating an asset's basis, but then could escape the overvaluation penalty by strategically conceding a deficiency on the ground of economic substance." *Ibid.* Despite their misgivings about the *Todd/Heasley* rule, however, Judge Prado and the other panel members ultimately concluded that, in light of binding circuit precedent, "our hands are tied." *Ibid.*

6. Citing *Bemont Investments*, as well as *Todd* and *Heasley*, a different panel of the Fifth Circuit affirmed the district court's penalty ruling in this case in a one-paragraph per curiam opinion, App., *infra*, 1a-2a, stating that "[w]e are convinced this issue is well settled," *id.* at 2a.

The government filed petitions for rehearing en banc in both *Bemont Investments* and this case. *Bemont Investments* became moot when the taxpayer elected to pay the overstatement penalty, see 10-41132 Docket entry (5th Cir. Aug. 2, 2012), and the Fifth Circuit denied rehearing in this case, App., *infra*, 23a-24a.

REASONS FOR GRANTING THE PETITION

The Fifth Circuit's interpretation of Section 6662 is inconsistent with the statute's text and basic purpose, and it conflicts with the holdings of eight other courts of appeals. Numerous similar cases, arising out of a wave of abusive tax shelters that were marketed to wealthy taxpayers primarily in the late 1990s and early 2000s, are currently pending in the Fifth and Ninth Circuits. This Court's review is necessary to prevent the federal fisc from being deprived of hundreds of millions of dollars in penalties from the worst tax scofflaws.

A. The Court Of Appeals Erred In Holding That Section 6662 Does Not Impose An Overstatement Penalty Where A Transaction Is Disregarded As Lacking Economic Substance

1. When a transaction designed to generate an artificially high basis in property is disregarded as lacking economic substance, the resulting underpayment of tax is "attributable to" an overstatement of basis within the meaning of Section 6662.

a. Section 6662 provides that the overstatement penalty shall apply to "the portion of any underpayment which is attributable to * * * [a] substantial valuation misstatement." 26 U.S.C. 6662(b)(3); see 26 U.S.C. 6662(h)(1) (applying greater penalty to the "portion of the underpayment * * * attributable to one or more gross valuation misstatements"). The word "attributable" means "capable of being attributed," and to "attribute" is to "explain as caused or brought about by." *Webster's Third New International Dictionary of the English Language* 141, 142 (1993). As this Court explained in construing the words "gain attributable to such property" in another provision of the Internal Revenue Code, "the phrase 'attributable to' merely confines considera-

tion to that gain caused or generated by the property in question." *Braunstein* v. *Commissioner*, 374 U.S. 65, 70 (1963). An underpayment of tax therefore is "attributable to" an overstatement of value or basis if the overstatement caused the underpayment.

Accordingly, when a taxpayer has underpaid income tax as a result of a tax shelter designed to generate tax losses by artificially inflating his basis in property, the underpayment is "attributable to" an overstatement of basis. The COBRA tax-avoidance mechanism employed by respondent provides an apt illustration. As the district court explained, "the whole point of the COBRA strategy" was to create a huge paper loss by claiming that "the basis of each partnership's property was the cost of the 'long' currency options, while the 'short' options could be disregarded for tax purposes." App., *infra*, 19a. When assets of the two partnerships (stock in Sun Microsystems and Canadian dollars) were sold, the taxpayers, through their S corporations, claimed a basis in those assets equal to the price of the long options (more than $45 million) plus a small amount of cash contributed to the partnerships. The IRS determined, however, that because the transaction had no purpose other than to achieve a tax loss, the transaction must be disregarded in calculating tax liability, and that the correct basis therefore was zero. See *ibid.*; Trial Ex. 198, at D0198.0014; Trial Ex. 199, at D0198.0014.

For purposes of computing a taxpayer's gain or loss from the sale of property, "the loss shall be the excess of the adjusted basis * * * over the amount realized" from the sale. 26 U.S.C. 1001(a). The impropriety of the deductions that Woods and McCombs claimed did not result from any misrepresentation concerning the amounts they had realized from the sale of the distrib-

uted partnership assets. Rather, the deductions were improper because the claimed losses were premised on asserted bases that the IRS subsequently determined to be unfounded.

In its Notice of Final Partnership Administrative Adjustment, the IRS concluded that the taxpayers had "not established adjusted bases in their respective partnership interests in an amount greater than zero." Trial Ex. 198, at D0198.0032; Trial Ex. 199, at D0199.0032. If Woods and McCombs had used that zero figure in calculating their own tax liabilities, they would have paid substantially more tax. It follows that Woods's and McCombs's underpayments of tax were "attributable to"—that is, were caused by—the overstatement of their basis in their partnership interests. "Had it not been for the valuation overstatement," Woods and McCombs "would not have underpaid [their] taxes." *Illes* v. *Commissioner*, 982 F.2d 163, 167 (6th Cir. 1992) (per curiam), cert. denied, 507 U.S. 984 (1993).

b. The fact that Woods and McCombs were not allowed to take any deduction at all provides no sound reason to treat Section 6662's overstatement penalty as inapplicable. The statute sets forth "no exception for when the valuation or basis misstatements are so egregious that the entire tax benefit is disallowed, and no suggestion that the penalty should not apply when the correct basis or value is determined to be zero because the transaction is completely lacking in economic substance." *Gustashaw* v. *Commissioner*, No. 11-15406, 2012 WL 4465190, at *10 (11th Cir. Sept. 28, 2012). Regardless whether an underpayment of tax results from an overstatement of a zero basis or an overstatement of a basis greater than zero, it is "attributable to" an overstatement of basis.

Even if Section 6662 were ambiguous on this question, the issue was resolved in 1991 by Treasury Regulation 1.6662-5(g), which provides that "[t]he value or adjusted basis claimed on a return of any property with a correct value or adjusted basis of zero is considered to be 400 percent or more of the correct amount." 26 C.F.R. 1.6662-5(g). In that circumstance, "[t]here is a gross valuation misstatement with respect to such property." *Ibid.* That regulation reflects a reasonable interpretation of Section 6662 and is accordingly entitled to judicial deference. See *Chevron U.S.A. Inc.* v. *NRDC*, 467 U.S. 837, 842-845 (1984); see also *Mayo Found. for Med. Educ. & Research* v. *United States*, 131 S. Ct. 704, 711-714 (2011) ("We see no reason why our review of tax regulations should not be guided by agency expertise pursuant to *Chevron* to the same extent as our review of other regulations.").

2. In holding that Section 6662's overstatement penalty does not apply where a basis-inflating transaction is entirely disregarded, the Fifth Circuit has "misread the *Blue Book*'s elementary guidance." *Bemont Invs., L.L.C.* v. *United States*, 679 F.3d 339, 352 (5th Cir. 2012) (Prado, J., concurring) (discussing *Todd* v. *Commissioner*, 862 F.2d 540 (5th Cir. 1988)). As another court of appeals has explained, the Fifth Circuit arrived at its interpretation "not by considering how the 'attributable to' language should be read in light of its purpose * * * but rather because it glossed that requirement by reading language in a congressional tax document." *Fidelity Int'l Currency Advisor A Fund, LLC* v. *United States*, 661 F.3d 667, 673 (1st Cir. 2011) (*Fidelity*).

a. In *Todd*, the Fifth Circuit considered whether the overstatement penalty could be imposed on taxpayers who had claimed large deductions and tax credits as part

of a scheme involving the purchase of refrigerated containers for agricultural products. See 862 F.2d at 540-541. The IRS had concluded that for many participating taxpayers, including the plaintiffs, the deductions and credits were improper in their entirety because the containers had not been placed in service in the years in which the deductions had been taken. See *id.* at 541. It had also determined that all participating taxpayers had vastly overstated their bases in the property by counting as part of the purchase price of each container not only the cash paid, but also the principal amount of an illusory promissory note. See *ibid.*

The Fifth Circuit held that the penalty could not be imposed on the plaintiffs because their underpayment of tax was "attributable to" the disallowance of the deduction for failure to place the units in service during the relevant tax years, rather than to the overstatement of basis in the refrigerated units. See *Todd*, 862 F.2d at 541-545. The court deemed the words "attributable to" ambiguous as applied to a deduction that is disallowed in its entirety for a reason independent of the overstatement of basis. Finding the "formal legislative history" of the Economic Recovery Tax Act of 1981 unhelpful on the question, the court turned to the formula set forth in the *Blue Book*. *Id.* at 542-543; see *Blue Book* 333. The Fifth Circuit reasoned that the plaintiffs' "actual tax liability" was no greater than their "actual tax liability as reduced by taking into account the valuation overstatement," because in either case the plaintiffs' deductions and credits would be completely disallowed for failure to place the refrigerated units in service in the relevant tax years. See *Todd*, 862 F.2d at 542-543 (citations omitted).

That conclusion rested on a clear misreading of the statute. Under the plain terms of Section 6662, the rele-

vant question is whether the underpayment of tax is "attributable to" an overstatement of value or basis. By overstating their basis in the property, the plaintiffs in *Todd* claimed a larger deduction—and thus made a larger underpayment of tax—than they would have made if their basis in the refrigerated units had been accurately reported. To be sure, even accurate reporting of the plaintiffs' basis in the units would have resulted in *some* underpayment of tax, given the IRS's determination that no deduction was permissible because the units had not been placed in service. But the difference between that smaller underpayment and the larger underpayment that actually occurred is naturally characterized as "attributable to" the basis overstatement. See *Todd* v. *Commissioner*, 89 T.C. 912, 914 (1987) (noting that the government sought the basis-overstatement penalty "only with respect to the difference between the basis claimed on the return * * * and [the plaintiffs'] cash investment"), aff'd, 862 F.2d 540 (5th Cir. 1988). And "a[n] interpretation of the statute that allows imposition of a valuation misstatement penalty even when other grounds are asserted furthers the congressional policy of deterring abusive tax avoidance schemes." *Alpha I, L.P.* v. *United States*, 682 F.3d 1009, 1030 (Fed. Cir. 2012), petition for cert. pending, No. 12-550 (filed Nov. 1, 2012); cf. *Saudi Arabia* v. *Nelson*, 507 U.S. 349, 375 (1993) (Kennedy, J., concurring in part and dissenting in part) (explaining that "a single injury can arise from multiple causes, each of which constitutes an actionable wrong") (citing Restatement (Second) of Torts §§ 447-449, at 478-482 (1965)).[7]

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[7] The anomalous nature of the Fifth Circuit's approach in *Todd* is particularly apparent given the treatment of other investors involved in the same Tax Court proceedings. Those other investors had actu-

As numerous judges have observed, the court in *Todd* simply misapplied the *Blue Book*'s guidance. The *Blue Book* described a case involving two *different* improper deductions, one of which is excessive because it is based on a valuation overstatement, and the other of which "is disallowed totally for reasons apart from the valuation overstatement." *Blue Book* 333 n.2. The question in *Todd*, by contrast, was how to apply Section 6662 when a single deduction is tainted both by a basis misstatement and by an unrelated legal defect. The *Blue Book* does not speak directly to that question.

b. In *Heasley* v. *Commissioner*, 902 F.2d 380 (1990), the Fifth Circuit "exacerbated *Todd*'s misunderstanding," *Bemont Invs.*, 679 F.3d at 352 (Prado, J., concurring), by holding that Section 6662 is inapplicable to *any* deduction that is disallowed in full, even when the ground for disallowance is intimately connected to a value or basis overstatement. The Heasleys had claimed an investment tax credit based on a hugely inflated basis in certain energy savings units, each of which they had valued at $100,000, even though they were worth only $4800. See 902 F.2d at 381-382 & nn. 2, 4. The IRS had disallowed the tax credit in its entirety on a number of factually related grounds, including that the taxpayers "did not have a profit objective" and "that the units were overvalued." *Heasley* v. *Commissioner*, 57 T.C.M.

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ally placed their refrigerated units in service but (like the Todds) had claimed inflated bases in the assets. The Tax Court held that those taxpayers *were* liable for penalties for the "portions of their tax deficiencies 'attributable to valuation overstatements.'" *Todd*, 862 F.2d at 541 (brackets omitted) (discussing Tax Court proceedings). The effect of the Fifth Circuit's approach thus was to treat the *additional* flaw in the Todds' claimed deduction (*i.e.*, their failure to place the units in service) as a ground for *avoiding* the overstatement penalty.

(P-H) ¶ 88,408, at 2039 (1988).[8] In imposing the overstatement penalty, the Tax Court had distinguished *Todd* on the ground that "[i]n the instant case, we made specific findings as to value," which led it to conclude that, "to the extent the underpayment is due to the disallowed credits, the underpayment is attributable to a valuation overstatement." *Ibid.*

Seeing "no reason to treat this case any differently than *Todd*," the Fifth Circuit reversed and held that "[w]henever the I.R.S. totally disallows a deduction or credit, the I.R.S. may not penalize the taxpayer for a valuation overstatement included in that deduction or credit." *Heasley*, 902 F.2d at 383. "In such a case," it concluded, "the underpayment is not attributable to a valuation overstatement. Instead, it is attributable to claiming an improper deduction or credit." *Ibid.* That was so "even if the possible grounds for denying the same deduction—overvaluation and lack of economic substance, for example—emerge from the same factual nucleus." *Bemont Invs.*, 679 F.3d at 353 (Prado, J., concurring). And, as in *Todd*, the Fifth Circuit in *Heasley* applied that approach even though it was evident that the taxpayers' overstatement of basis had caused the size of the claimed deduction (and thus the amount of their underpayment) to be greater than it would otherwise have been.

c. In this case, the taxpayers' overstatements of their bases in the purported partnership were integral to their tax-avoidance scheme. As explained above, a taxpayer's "loss" from the sale of property is "the excess of the adjusted basis * * * over the amount realized." 26

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[8] In *Soriano* v. *Commissioner*, 90 T.C. 44 (1988), the test case for the transaction at issue in *Heasley*, the court couched its analysis in terms of economic substance.

U.S.C. 1001(a). The district court ultimately determined that Woods and McCombs each had an adjusted basis of zero in his partnership interests in the two partnerships. If Woods and McCombs had used that zero figure in calculating their own tax liabilities, they would not have claimed a loss on the sale of the distributed partnership assets, and their reported tax liabilities would have been much higher. The underpayments that actually occurred therefore were "attributable to" the basis overstatements under any usual understanding of that term.

d. The Fifth Circuit's interpretation of Section 6662 frustrates the obvious purpose of the overstatement penalty of deterring taxpayers from misrepresenting their bases in property to achieve unwarranted tax reductions. See *Fidelity*, 661 F.3d at 673-674. It exempts from the penalty taxpayers who engage in transactions specifically designed to inflate the value or basis in property merely because it is determined that they should not have taken any deduction at all. Congress could not have envisioned that outcome. As one court has remarked, "it is particularly dubious that Congress intended to confer * * * largesse upon participants in tax shelters, whose intricate plans for tax avoidance often run afoul of the economic substance doctrine." *Clearmeadow Invs., LLC* v. *United States*, 87 Fed. Cl. 509, 534 (2009).

B. Eight Circuits Have Rejected The Fifth Circuit's Interpretation Of Section 6662's Overstatement Penalty, While Only The Ninth Circuit Has Adopted It

There is a lopsided but intractable division among the circuits over whether a taxpayer's underpayment of tax can be "attributable to" a misstatement of basis where the transaction that created an inflated basis is disregarded in its entirety as lacking economic substance.

Eight circuits have concluded that "when an underpayment stems from deductions that are disallowed due to a lack of economic substance, the deficiency is attributable to an overstatement of value and is subject to the penalty of [Section 6662]." *Merino* v. *Commissioner*, 196 F.3d 147, 155 (3d Cir. 1999) (quoting *Zfass* v. *Commissioner*, 118 F.3d 184, 190 (4th Cir. 1997)). Only the Ninth Circuit has adopted the Fifth Circuit's interpretation, although some judges on the Ninth Circuit (like the members of the *Bemont Investments* panel) have expressed skepticism about that approach. See *Keller* v. *Commissioner*, 556 F.3d 1056, 1061 (9th Cir. 2009). In denying rehearing en banc in this case despite Judge Prado's concurrence in *Bemont Investments*, the Fifth Circuit has now made clear that it has no intention of revisiting its "well settled" precedent. App., *infra*, 2a. This Court should accordingly resolve the circuit conflict.

1. There is "near-unanimous opposition to the *Todd/Heasley* rule" among federal courts of appeals. *Bemont Invs.*, 679 F.3d at 354 (Prado, J., concurring). Eight of the ten circuits that have considered the question have held that the overstatement penalty can apply where a transaction is disregarded as lacking economic substance.

a. In *Massengill* v. *Commissioner*, 876 F.2d 616 (1989), decided one year before *Heasley*, the Eighth Circuit upheld the Tax Court's imposition of the overstatement penalty on taxpayers whose depreciation deductions for cattle were disallowed in full because their purchase of the cattle was a sham. See *id.* at 618. Reasoning that the taxpayers' "correct basis in the cows was zero because no sale had taken place," the court held that "[w]hen an underpayment stems from disallowed

depreciation deductions or investment credit[s] due to lack of economic substance, the deficiency is attributable to [an] overstatement of value, and subject to the penalty." *Id.* at 619-620.[9]

Two years later, the Second Circuit reached the same conclusion in *Gilman* v. *Commissioner*, 933 F.2d 143 (1991), cert. denied, 502 U.S. 1031 (1992). The court in *Gilman* approved the Tax Court's imposition of the overstatement penalty on a taxpayer who had participated in a sham sale-leaseback arrangement that had the effect of assigning an artificially high purchase price to computer equipment, enabling the taxpayer to take large depreciation deductions. See *id.* at 145. Although the Second Circuit believed that "the application of [the overstatement penalty] to a transaction determined to be without economic substance is not self-evident," the court ultimately "agree[d] with the Tax Court and with the Eighth Circuit" that "[w]here a transaction is not respected for lack of economic substance, the resulting underpayment is attributable to the implicit overvaluation." *Id.* at 151-152. The Second Circuit expressly rejected that taxpayer's reliance on *Todd* and *Heasley* and noted that "application of the [overstatement] penalty" to transactions lacking economic substance "surely reinforces the Congressional objective of lessening tax shelter abuse." *Id.* at 151.

In *Illes*, *supra*, the Sixth Circuit followed *Massengill* and *Gilman* in upholding the imposition of the overstatement penalty on a taxpayer who had claimed de-

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[9] The Eighth Circuit distinguished *Todd* on the ground that "[t]he taxpayer in *Todd* had acquired property"—*i.e.*, the transactions had not been disregarded due to a lack of economic substance, but the deduction had been disallowed for a reason unrelated to the basis overstatement. See *Massengill*, 876 F.2d at 619.

preciation deductions and investment tax credits for certain master recordings leased in connection with a sham business enterprise. See *Illes*, 982 F.2d at 165-166. As part of the scheme, the taxpayer had claimed an interest in the recordings that "exceeded their correct value by more than 250%." *Id.* at 166. The court rejected the premise of *Heasley* that "[s]ince [the taxpayer's] underpayment is the result of the [shelter] being an economic sham * * * the underpayment is attributable to his claiming an improper deduction rather than a valuation overstatement," calling that "a false distinction." *Id.* at 166-167. The taxpayer's underpayment of tax, the Sixth Circuit reasoned, "[p]lainly * * * was attributable to his valuation overstatement" because "[t]he entire artifice of the [tax] shelter was constructed on the foundation of the overvaluation of its assets." *Id.* at 167. Simply stated, "[h]ad it not been for the valuation overstatement, [the taxpayer] would not have underpaid his taxes." *Ibid.*[10]

The Third and Fourth Circuits subsequently reached the same conclusion. See *Merino*, 196 F.3d at 155; *Zfass*, 118 F.3d at 190-191. Those courts have expressly rejected *Heasley* in favor of the rule adopted by "[t]he Second, Sixth, and Eighth Circuits * * * that when an underpayment stems from deductions that are disallowed due to a lack of economic substance, the deficien-

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[10] Although the taxpayer in *Illes* did not rely on *Heasley*, the court cited an unpublished opinion in which it had rejected the *Heasley* analysis in favor of the Second Circuit's approach in *Gilman*. *Illes*, 982 F.2d at 167 n.1; see *Donahue* v. *Commissioner*, No. 91-1849, 1992 WL 70174, at *4 (6th Cir. Apr. 7, 1992) (959 F.2d 234 (6th Cir. 1992) (Table)). Like the Eighth Circuit in *Massengill*, the Sixth Circuit distinguished *Todd* on the ground that, in that case, "the claimed deduction was improper without regard to whether the investors overvalued their interests in the property." *Illes*, 982 F.2d at 167.

cy is attributable to an overstatement of value and is subject to penalty." *Zfass*, 118 F.3d at 190; see *Merino*, 196 F.3d at 155, 158 (joining the "majority of the Courts of Appeals that have addressed this issue" in upholding the imposition of the overstatement penalty where "the overvaluation of the property in question * * * is an essential component of the tax avoidance scheme" disregarded as lacking economic substance). Both courts also suggested that the decision in *Heasley* "appear[ed] to have been driven by understandable sympathy for the Heasleys rather than by a technical analysis of the statute." *Merino*, 196 F.3d at 158; see *Zfass*, 118 F.3d at 190 n.8.

b. These earlier decisions applying the overstatement penalty to transactions lacking economic substance concerned relatively simple schemes in which the sham transaction was designed to facilitate depreciation deductions or investment credits for overvalued assets. Recent decisions of the First, Federal, and Eleventh Circuits have adopted the majority interpretation and applied it to sophisticated tax shelters similar to COBRA.

In *Fidelity*, the First Circuit held the overstatement penalty applicable to two tax shelters that, like COBRA, involved the contribution of offsetting option positions to a partnership in order to generate an artificially high basis in a partnership interest. See 661 F.3d at 668-670. The court rejected the taxpayer's argument that, because there were multiple legal grounds for denying the deduction, all "stemming from the same central finding that the transactions lacked economic purpose," the penalty could not apply. *Id.* at 672-673. "Congress' phrase 'attributable to,'" it explained, "is easily read to cover the role of the misstatements in lowering [the taxpay-

er's] taxes and that reading serves the underlying policy" of the penalty. *Id.* at 673. The First Circuit also observed, citing the 5-to-2 circuit conflict that existed at that time, that "[m]ost circuit courts that have confronted variations of [the taxpayer's] argument in the lack of economic substance context have rejected it"; and it concluded that the Fifth Circuit's approach "rests on a misunderstanding of the sources relied on" (*e.g.*, the *Blue Book*). *Ibid.*

Shortly after the Fifth Circuit issued its opinion in *Bemont Investments*, the Federal Circuit also addressed the applicability of the overstatement penalty to a shelter designed to generate an artificially high basis in property contributed to a partnership. See *Alpha I, L.P.*, 682 F.3d at 1013-1014. The Court of Federal Claims had granted summary judgment to the taxpayer on the ground that, under the reasoning of *Todd*, the penalty did not apply because the taxpayer had conceded that it was not entitled to a deduction on a ground unrelated to the basis misstatement. See *id.* at 1026-1027. The Federal Circuit reversed that holding. The court stated that it "disagree[d] with the legal analysis employed in *Todd*[,] * * * finding it flawed in material respects," pointing to the same misapplication of the *Blue Book*'s guidance that Judge Prado had identified. *Id.* at 1028-1029. It noted that "every circuit court to have addressed the issue, except the Ninth Circuit * * *, has rejected *Todd*'s reasoning." *Id.* at 1030. The court also made clear that on remand, the Court of Federal Claims was not free to follow *Heasley*'s extension of *Todd* either, instructing the court to "focus[] on the role that any valuation misstatements played in attaining any improper tax benefits" and citing *Fidelity*, *Gilman*, and *Merino*. *Id.* at 1030-1031.

Most recently, in *Gustashaw*, the Eleventh Circuit upheld the imposition of the overstatement penalty in the context of another basis-inflating shelter disregarded for lack of economic substance. Finding "no suggestion" in the statute "that the penalty should not apply when the correct basis or value is determined to be zero because the transaction is completely lacking in economic substance," the court noted that *Alpha I*, *Fidelity*, *Merino*, *Zfass*, *Illes*, *Gilman*, and *Massengill* were all in accord with its view. *Gustashaw*, 2012 WL 4465190, at *10. It found "the majority rule to be the better interpretation" of Section 6662 because that "rule rests upon the fact that the abusive tax shelter is built upon the basis misstatement, and the transaction's lack of economic substance is directly attributable to that misstatement." *Id.* at *11.

2. Departing from the approach taken by the majority of circuits, the Ninth Circuit has adopted the holdings of both *Todd* and *Heasley*. As a result, the IRS has been prevented from collecting overstatement penalties from taxpayers who employ abusive tax shelters in circuits covering more than 90 million people.

The Ninth Circuit adopted the *Todd* rule in *Gainer* v. *Commissioner*, 893 F.2d 225 (1990), which arose out of the same refrigerated-units scheme involved in *Todd*.[11] The Ninth Circuit agreed with the Fifth Circuit that the phrase "attributable to" is ambiguous and that the "formal legislative history * * * does not discuss how to determine whether a tax underpayment is 'attributable to' an overvaluation of property." *Id.* at 227. Like the Fifth Circuit, it went on to read the *Blue Book*'s guid-

[11] As in *Todd*, the deductions and credits in *Gainer* had been disallowed because the property had not been placed in service in the relevant tax years.

ance to mean that where there are two independent causes of the same under-reporting error, only one of which is an overstatement of value or basis, the penalty cannot apply. See *id.* at 227-228.

The Ninth Circuit then adopted *Heasley* in *Keller*, *supra*. *Keller* involved a shelter designed to generate depreciation deductions by inflating the taxpayer's basis in cattle that he had never truly acquired. See 556 F.3d at 1057-1058. The Tax Court had held that, because the taxpayer "had in fact not acquired any cattle, his basis in the cattle would be zero for the relevant tax years, far below the claimed bases, and thus supported the 40 percent penalty for gross valuation misstatements." *Id.* at 1058. Reversing, the Ninth Circuit found *Gainer* "directly on point" and held that "[w]hen a depreciation deduction is disallowed in total, any overvaluation is subsumed in that disallowance, and an associated tax underpayment is 'attributable to' the invalid deduction, not the overvaluation of the asset." *Id.* at 1060-1061. It concluded that the taxpayer's "tax deficiency was 'attributable to' taking a depreciation deduction to which he was not entitled (at all) rather than 'attributable to' overvaluation." *Ibid.*

The court in *Keller* "recognize[d] that many other circuits have concluded that when overvaluation is intertwined with a tax avoidance scheme that lacks economic substance, an overvaluation penalty can apply." 556 F.3d at 1061; see *id.* at 1061 n.5 (explaining that in *Heasley* the "Fifth Circuit * * * interpreted its holding in *Todd* the same way" as the court was interpreting *Gainer*). The court further acknowledged that "[t]his sensible method of resolving overvaluation cases cuts off at the pass what might seem to be an anomalous result—allowing a party to avoid tax penalties by engag-

ing in behavior one might suppose would implicate more tax penalties, not fewer." *Id.* at 1061. But it deemed itself "constrained by *Gainer*" to adopt the minority rule. *Ibid.* The Ninth Circuit denied the government's petition for rehearing en banc, even though two panel members favored further review. See 06-75441 Docket entry No. 65 (May 20, 2009).

3. The conflict of authority is ripe for resolution. Every court of appeals except the Seventh, Tenth, and D.C. Circuits has addressed the issue, and eight have adopted the government's reading of the statute. Both the Fifth and Ninth Circuits have denied the government's petitions for rehearing en banc in recent years, and the Fifth Circuit has stated that the issue is "well settled" in that circuit. App., *infra*, 2a. Absent further review by this Court, taxpayers in different States therefore will continue to be subject to different IRS enforcement regimes.

This case is a suitable vehicle to resolve the issue. The question is squarely presented, and respondent did not appeal the district court's conclusion that COBRA was a transaction lacking economic substance designed to artificially inflate the basis in partnership interests.[12]

C. The Question Presented Is Important To The Efficient And Fair Administration Of The Internal Revenue Code

If left undisturbed, the minority rule of the Fifth and Ninth Circuits will continue to cost the federal fisc hundreds of millions of dollars in forgone penalties from taxpayers who have employed abusive tax shelters. The

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[12] Respondent filed a notice of appeal from the district court's judgment but later voluntarily withdrew his appeal. See 11-50487 Docket entry (5th Cir. Dec. 13, 2011).

entrenched position of those circuits has also led to arbitrary and unfair variation in the federal government's enforcement of the Internal Revenue Code.

1. a. In the decade preceding the 2008 financial crisis, there was a substantial increase in high-dollar, basis-inflating tax shelters employed by U.S. taxpayers. See Permanent Subcomm. on Investigations of the Comm. on Homeland Sec. & Governmental Affairs, *The Role of Professional Firms in the U.S. Tax Shelter Industry*, S. Rep. No. 54, 109th Cong., 1st Sess. 9-11 (2005). Unlike in previous eras, "the U.S. tax shelter industry was no longer focused primarily on providing individualized tax advice to persons who initiate contact with a tax advisor," but rather was "developing a steady supply of generic 'tax products' that [were] aggressively marketed to multiple clients." *Id.* at 9. Those standardized shelters, with names like COBRA, BOSS, BLIPS, and FLIP, were marketed to wealthy individuals by accounting firms, law firms, investment banks, and others. See *id.* at 5-7.

As a consequence of this wave of abusive tax shelters, there has been an explosion of litigation in the federal courts involving the IRS's attempts to recoup unpaid taxes and impose penalties on those who participated in and marketed these shelters. Many of the cases appealable to the Fifth or Ninth Circuit involve millions of dollars in potential penalties. See, *e.g.*, *Chemtech Royalty Ass'n LLP* v. *United States*, No. 3:05-cv-944 (M.D. La. trial concluded June 27, 2011) ($360 million basis misstatement). If the rule adopted by those circuits is allowed to stand, the federal government will be deprived of substantial revenue that is owed by wealthy individuals or companies that attempted to avoid their tax obligations by participating in abusive tax shelters.

b. In 2010, Congress added to Section 6662 a new subsection that imposes a 40% penalty on any underpayment of tax that is attributable to a "nondisclosed noneconomic substance transaction" entered into after March 30, 2010. 26 U.S.C. 6662(i) (Supp. V 2011). Although this provision may eventually lessen the impact of the Fifth and Ninth Circuit's flawed interpretation of the overstatement penalty, it has no application to the thousands of taxpayers who engaged in abusive, basis-inflating tax shelters before the provision's effective date—and the millions of dollars in penalties they owe to the federal treasury. Section 6662(i) will have no effect, moreover, on cases where value- or basis-related deductions are disallowed in full on a ground other than lack of economic substance. See, *e.g.*, *Derby* v. *Commissioner*, 95 T.C.M. (CCH) 1177, 1194 (2008).

2. Without further review by this Court, the interpretation of Section 6662's overstatement penalty adopted by the Fifth and Ninth Circuits will continue to foster "inequalities in the administration of the revenue laws." *Commissioner* v. *Sunnen*, 333 U.S. 591, 599 (1948). Taxpayers who participated in basis-inflating tax shelters and who reside in the Fifth or Ninth Circuit are currently exempt from the overstatement penalty, but taxpayers elsewhere who participated in the same tax shelters are not. See, *e.g.*, *Murfam Farms, LLC* v. *United States*, 94 Fed. Cl. 235 (2010) (upholding the overstatement penalty in a case involving COBRA). Such arbitrary differences in treatment threaten the government's ability to enforce the Internal Revenue Code in an even-handed manner.

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted.

DONALD B. VERRILLI, JR.
Solicitor General
KATHRYN KENEALLY
Assistant Attorney General
MALCOLM L. STEWART
Deputy Solicitor General
JOHN F. BASH
Assistant to the Solicitor General
GILBERT S. ROTHENBERG
RICHARD FARBER
ARTHUR T. CATTERALL
Attorneys

NOVEMBER 2012

APPENDIX A

UNITED STATES COURT OF APPEALS
FOR THE FIFTH CIRCUIT

No. 11-50487

GARY WOODS, AS TAX MATTERS PARTNER OF TESORO DRIVE PARTNERS, A TEXAS GENERAL PARTNERSHIP,
PLAINTIFF-APPELLEE

v.

UNITED STATES OF AMERICA, DEFENDANT-APPELLANT

Filed: June 6, 2012

Appeal from the United States District Court
for the Western District of Texas
USDC No. 5:05-cv-00216

Before: JONES, Chief Judge, and WIENER and GRAVES, Circuit Judges.

PER CURIAM:*

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* Pursuant to 5TH CIR. R. 47.5, the court has determined that this opinion should not be published and is not precedent except under the limited circumstances set forth in 5TH CIR. R. 47.5.4.

This Court has considered this appeal on the basis of the briefs and the record on appeal. Having done so, we are convinced that this issue is well settled and that the district court should be affirmed. *See Bemont Invs., L.L.C. v. United States*, No. 10-41132, 679 F.3d 339 (5th Cir. Apr. 26, 2012); *Heasley v. Comm'r of Internal Revenue*, 902 F.2d 380 (5th Cir. 1990); *Todd v. Comm'r of Internal Revenue*, 862 F.2d 540 (5th Cir. 1988).

AFFIRMED.

APPENDIX B

UNITED STATES DISTRICT COURT
FOR THE WESTERN DISTRICT OF TEXAS

Nos. SA-05-CA-216, SA-05-CA-217

GARY WOODS, AS TAX MATTERS PARTNER OF TESORO DRIVE PARTNERS, PLAINTIFF

v.

UNITED STATES OF AMERICA, DEFENDANT

GARY WOODS, AS TAX MATTERS PARTNER OF SA TESORO INVESTMENT PARTNERS, PLAINTIFF

v.

UNITED STATES OF AMERICA, DEFENDANT

Mar. 21, 2011

ORDER REGARDING OBJECTIONS TO ACCURACY-RELATED PENALTIES

HARRY LEE HUDSPETH, Senior District Judge.

Plaintiff Gary Woods, in his capacity as Tax Matters Partner for two general partnerships[1] filed these petitions for judicial review of final partnership administrative adjustments made by the Internal Revenue Service with respect to the partnership returns for taxable year 1999. As the principal place of business of each partnership was located in San Antonio, Texas, this Court has jurisdiction under 26 U.S.C. § 6226(a)(2). Following a bench trial in September 2010, the Court entered an order granting the Defendant's motion for judgment as a matter of law. In doing so, the Court held that the ordinary and capital losses claimed in the partnership tax returns were properly disallowed by the Commissioner, because the complicated series of transactions which generated the purported paper losses lacked economic substance. Accordingly, the Court held that the Defendant was entitled to judgment in its favor with respect to the administrative adjustments to the partnership returns of Tesoro Drive Partners and SA Tesoro Investment Partners. Left unresolved was the question whether the imposition of accuracy-related penalties was justified. The Court invited the parties to submit briefs on that question, and those briefs were filed. The issue is now ripe for decision.

As noted in the Order Granting Defendant's Motion for Judgment as a Matter of Law, the partnership tax

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[1] The partnerships in question were Tesoro Drive Partners (Cause No. SA-05-CA-216) and SA Tesoro Investment Partners (Cause No. SA-05-CA-217).

items at the center of this dispute resulted from the November 1999 decision of Plaintiff Woods to participate, on his own behalf and on behalf of his associate, Billy Joe "Red" McCombs, in a tax shelter known as COBRA.[2] This tax avoidance strategy was dreamed up by the law firm of Jenkins & Gilchrist, marketed by the accounting firm of Ernst & Young, and assisted in its implementation by another law firm, Brown & Wood, A few selected high net worth individuals were invited in the year 1999 to participate in COBRA, which even its proponents described as an "aggressive" strategy. Its purpose, in common with other forms of tax shelters, was to generate large paper losses to be set off against large amounts of income which a participant expected to receive in that particular year.

At the time that Woods elected to participate in COBRA in November 1999, barely enough time remained to complete all the steps required by the COBRA scenario before December 31st of that year. However, the two Tesoro partnerships, under the guidance of Woods, did complete the process in time to transfer all their remaining assets to two Sub-chapter S corporations,[3] effectively liquidating both partnerships. Those two Sub-chapter S entities then sold the assets, which the tax returns claimed resulted in an ordinary loss of $13,353,162 and a short-term capital

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[2] The initials COBRA stands for "Current Options Bring Reward Alternatives."

[3] Those corporations were Tesoro Drive Investors, Inc. and SA Tesoro Investors, Inc.

loss of $32,297,786. In the final partnership administrative adjustments, these losses were disallowed.

The Defendant contends that in addition to disallowing the losses claimed on the partnership returns, the Commissioner was justified in imposing three categories of accuracy-related penalties: (1) a penalty for gross or substantial misstatement of valuation; (2) a penalty for negligence or disregard of rules and regulations; and (3) a penalty for substantial understatement of income tax. 26 U.S.C. § 6662. The Court will discuss each category in turn.

With respect to the first penalty, the statute defines "valuation misstatement" as including misstatements relating either to value or to basis, 26 U.S.C. § 6662(e)(1)(A). In this Circuit, however, it is clearly established that whenever the Internal Revenue Service totally disallows a deduction, it may not penalize the taxpayer for a valuation overstatement included in that deduction. In such a case, the underpayment is not attributable to a valuation overstatement; it is attributable to claiming an improper deduction. *Heasley v. Commissioner of Internal Revenue*, 902 F.2d 380, 383 (5th Cir. 1990). Counsel for the Defendant contends that because of the passage of time and intervening events, *Heasley* is no longer good law. However, until and unless *Heasley* is overruled by the Court of Appeals or the Supreme Court, this Court is bound by its holding.[4] The Court must respectfully

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[4] The Court of Appeals for the Fifth Circuit has been invited to revisit *Heasley* in a case styled *Southgate Master Fund v. United*

decline the invitation by defense counsel to overrule the Court of Appeals.

The Commissioner next imposed a penalty on the alleged underpayment of tax based on a finding of negligence or disregard of rules and regulations on the part of the taxpayer, pursuant to 26 U.S.C. §§ 6662(a) and (b)(1). The statute defines "negligence" to include any failure to make a reasonable attempt to comply with the provisions of the Internal Revenue Code, and "disregard" to include reckless or intentional, as well as careless, conduct. § 6662(c).

The inquiry into a taxpayer's negligence has been described as "highly individualized," *Merino v. Commissioner*, 196 F.3d 147, 154 (3rd Cir. 1999), but the Court should begin that inquiry by matching the taxpayer's conduct against that of a reasonably prudent person. *Heasley*, 902 F.2d at 383; *Marcello v. Commissioner*, 380 F.2d 499, 506 (5th Cir. 1967). Negligence may be indicated by a taxpayer's failure to question a deduction which seems "too good to be true." *Hansen v. Commissioner*, 471 F.3d 1021, 1029 (9th Cir. 2006). The justification for the imposition of a penalty may be even more clearly defined if the circumstances indicate reckless or intentional disregard, not just a failure to exercise ordinary-care. *Marcello*, 380 F.2d at 506.

Where, as here, the Commissioner's finding of negligence and/or disregard is challenged, it is appropri-

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States, Appeal No. 09-11166. At this writing, the Court of Appeals has held oral argument in that appeal, but has not ruled.

ate for the Court to consider the level of knowledge and sophistication of the individual taxpayer. *Merino*, 196 F.3d at 154. In this case, Plaintiff Woods' knowledge of business in general and accounting in particular was both broad and deep. He earned a Bachelor's degree in business administration from Southwest Texas State (now Texas State) University, and his formal education continued with a Master's degree from Southern Methodist University and course work toward a Ph.D. at the University of North Texas. He is a Certified Public Accountant, licensed in the State of Texas. His practical experience and business acumen are also impressive. He occupied a key management role in McCombs Enterprises, which invested in everything from car dealerships to professional sports teams in the National Basketball Association and the National Football League. Although Plaintiff Woods may not have qualified as a "tax specialist," he was a far cry from a man who had just fallen off a turnip truck. His wealth of knowledge and experience should have alerted him to the fact that the COBRA scheme was simply "too good to be true." Specifically, he was aware from the start that the complicated, rapid-fire, series of transactions called for by the COBRA plan were for the sole purpose of generating a large paper loss for tax purposes, and he also knew, or should have known, that these transactions did not possess "economic substance compelled by business or regulatory realities." *Klamath Strategic Investment Fund v. United States*, 568 F.3d 537, 544 (5th Cir. 2009). By Woods' own admission, he was aware that tax shelter entities are required to have a

business purpose, and to possess economic substance. Under all the circumstances, his tax treatment of the "losses" generated by the COBRA transactions on the Tesoro partnership returns was at best negligent, and at worst, reckless or intentional disregard of established regulations. Accordingly, the Commissioner was justified in imposing the penalty for negligence or disregard of rules and regulations.

The Commissioner imposed yet another accuracy related penalty on the portion of underpayment of tax which he concluded was attributable to a substantial understatement of income tax. Although such a penalty is authorized by § 6662(b)(2), the statute further provides that the amount of any such understatement would be reduced, if (1) the tax treatment of the item in question was based on "substantial authority," or (2) the relevant facts affecting the tax treatment of the item are disclosed in the return itself or an attached statement, and there is a reasonable basis for the treatment chosen by the taxpayer. § 6662(d)(2)(B), However, where, as here, a tax shelter is involved, the "disclosure prong" (§ 6662(d)(2)(B)(ii)) does *not* apply, and a heightened standard is applied to the "substantial authority" prong. § 6662(d)(2)(C). In the tax shelter context, the taxpayer must go beyond demonstrating the existence of substantial authority, and demonstrate his own reasonable belief that his treatment of the item in question was "more likely than not" the proper treatment of the item.

§ 6662(d)(2)(C)(i)(II).[5] It is beyond dispute that the cobra plan was a tax shelter, and that the Tesoro partnerships were organized for the specific purpose of executing the COBRA tax avoidance strategy. Therefore, the heightened standard applies.

Was there "substantial authority" for Woods' treatment of the COBRA induced tax loss? The short answer is, there was not. It was obvious to Woods, as it would have been to anyone with his background and experience, that the COBRA transactions did not possess economic substance, and were being undertaken for the sole purpose of establishing a large paper tax loss. To put it another way, COBRA was marketed to everyone, including Woods, as a tax shelter, and a tax shelter it was. Furthermore, the tax opinions rendered by the law firms of Jenkins & Gilchrist and Brown & Wood do not qualify as "substantial authority." Not only were those opinions tainted by the involvement of their authors in the COBRA scheme (of which more later), but the authorities on which those authors purport to rely cannot justify the deduction of paper losses generated by transactions lacking economic substance and executed for the sole purpose of creating a tax benefit.

Assuming *arguendo* the existence of substantial authority, Woods must further show that he "reasonably believed" that his tax treatment of the COBRA

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[5] The statute has been amended since these events occurred. Today, none of the exceptions contained in § 6662(d)(2)(B) are applicable to items attributable to a tax shelter.

losses was "more likely than not" the proper treatment of those items. § 6662(d)(2)(c)(i)(II). The reasonable belief requirement overlaps substantially with the "reasonable cause and good faith" defense found in 26 U.S.C. § 6664(c), and the two will be considered together.

The statutory "reasonable cause" exception to the penalty for underpayment of tax provides that no penalty will be imposed as to any portion of an underpayment with respect to which the taxpayer acted with reasonable cause and good faith. § 6664(c)(1). The taxpayer has the burden of establishing this defense. *Klamath*, 568 F.3d at 548, which has been described as a "narrow" defense. *Stobie Creek Investments LLC v. United States*, 608 F.3d 1366, 1381 (Fed. Cir. 2010). The existence or non-existence of reasonable cause is a question of fact decided on a case-by-case basis. Treas. Reg. § 1.6664-4(b)(1). As in most cases, Woods attempts to show reasonable cause by contending that he relied upon the advice of competent and independent professional advisers. *United States v. Boyle*, 469 U.S. 241, 251, 105 S. Ct. 687, 83 L. Ed. 2d 622 (1985); *Stobie Creek*, 608 F.3d at 1381.

Plaintiff Woods contends that he reasonably relied on the advice of an accounting firm, Ernst & Young, and two law firms, Jenkins & Gilchrist and Brown & Wood. However, he cannot sustain his burden of showing that his reliance on their advice was objectively reasonable. First, each of the three had an inherent conflict of interest which was too obvious to be ignored. *Chamberlain v. Commissioner*, 66 F.3d 729,

732 (5th Cir. 1995); *Stobie Creek*, 608 F.3d at 1382. The firm of Jenkins & Gilchrist was the inventor and promoter of the COBRA strategy, and Ernest & Young and Brown & Wood were, at the very least, agents of the promoter. From the moment he was first introduced to COBRA in November 1999, Woods had actual knowledge of the role of Jenkins & Gilchrist in developing, and Ernst & Young in marketing, the COBRA strategy. He also knew that the fees charged by each of those firms would be based on a percentage of the "desired loss"! Although the involvement of Brown & Wood was not known until later, Woods was told up front that a second opinion would be obtained for the purpose of making the tax deduction "penalty proof." The firm of Brown & Wood was not selected by Plaintiff Woods, but by Jenkins & Gilchrist, and its fee was not extra, hut was "carved out" of the fee paid to Jenkins & Gilchrist. In short, Brown & Wood was not an "independent" professional adviser in any common ordinary English language dictionary meaning of that word.

Second, Woods' claim of reliance on professional advice is not objectively reasonable because he knew or should have known that the COBRA tax benefit was "too good to be true" in light of all the circumstances, including his own education, business experience, sophistication, and his purpose in carrying out the COBRA transactions. Treas. Reg. § 1.6664-4(c); *Hansen*, 471 F.3d at 1032; *Stobie Creek*, 608 F.3d at 1382.

Third, any claim of reasonable reliance which might have been arguable prior to December 1999 dissolved

when the Internal Revenue Service issued, and when Ernst & Young and Woods became aware of, IRS Notice 99-59. That Notice unequivocally warned taxpayers that artificial losses of the COBRA kind were not properly allowable for federal income tax purposes. Ernst & Young personnel immediately grasped the significance of the IRS warning as it related specifically to COBRA, and just as quickly (1) discontinued marketing the strategy, and (2) notified its clients, including Plaintiff Woods. December 1999 was, of course, before the filing of the Tesoro partnership returns. If all the alerts previously discussed in this opinion could be termed "red flags," IRS Notice 99-59 was more like a dagger to the heart of any claim of reasonable reliance on advice received from the likes of Ernst & Young, Jenkins & Gilchrist, or Brown & Wood.

In summary, the Court finds that Plaintiff Woods has failed to sustain his burden of proving that when the partnership returns in this case were filed, he reasonably believed that his tax treatment of the purported losses was "more likely than not" the proper treatment of these items, or that he acted with reasonable cause or good faith, as case law has defined those terms. The Commissioner's imposition of a penalty on that portion of the underpayment attributable to the substantial understatement of income tax should be affirmed.

In light of the foregoing discussion, the Court finds that the following orders should be entered.

IT IS ORDERED that the Commissioner's imposition of a penalty for misstatement of valuation be, and it is hereby, REVERSED.

IT IS FURTHER ORDERED that, in all other respects, judgment be, and it is hereby, entered in favor of the Defendant United States of America, and that the rulings of the Commissioner of Internal Revenue be, and they are hereby, AFFIRMED.

APPENDIX C

UNITED STATES DISTRICT COURT
FOR THE WESTERN DISTRICT OF TEXAS

Nos. SA-05-CA-216-H, SA-05-CA-217-H

GARY WOODS, AS TAX MATTERS PARTNER OF TESORO DRIVE PARTNERS, PLAINTIFF

v.

UNITED STATES OF AMERICA, DEFENDANT

GARY WOODS, AS TAX MATTERS PARTNER OF SA TESORO INVESTMENT PARTNERS, PLAINTIFF

v.

UNITED STATES OF AMERICA, DEFENDANT

Sept. 21, 2010

ORDER GRANTING DEFENDANT'S MOTION FOR JUDGMENT AS A MATTER OF LAW

HARRY LEE HUDSPETH, Senior District Judge.

These two consolidated cases are petitions for judicial review of final partnership administrative adjustments, with jurisdiction in this Court

founded upon 26 U.S.C. § 6226(a)(2). In cause number SA-05-CA-216, Plaintiff Gary Woods is requesting the Court to order the readjustment of certain items in the partnership return of Tesoro Drive Partners, a Texas general partnership, for the calendar year 1999. In cause number SA-05-CA-217, the same Plaintiff, Gary Woods, is requesting the Court to order the readjustment of items in the partnership return of SA Tesoro Investment Partners, a Texas general partnership, for the same calendar year. The two cases were consolidated for trial, and beginning September 13, 2010, were tried to the Court without the intervention of a jury. On September 16, 2010, the Plaintiff rested his case-in-chief, and the Defendant moved for judgment in its favor as a matter of law. The Court, having considered the motion, found that it should be granted.

This is a hard case, but not a difficult one. Billy Joe "Red" McCombs is a successful and famous Texas entrepreneur, civic leader, and philanthropist. He is also well known outside the State of Texas, partly because of his former ownership of national sports franchises, including the San Antonio Spurs professional basketball team and the Minnesota Vikings professional football team. His numerous and diversified business interests and investments are gathered under the umbrella of McCombs Enterprises, a sole proprietorship headquartered in San Antonio, Texas. For more than 30 years, his "right-hand man" has been Gary Woods, the Plaintiff in this case, who holds the title of President of McCombs Enterprises. A high

degree of trust and confidence exists between McCombs and Woods. In fact, on December 15, 1993, McCombs executed a universal power of attorney in favor of Woods, which generally authorizes the latter to take any action on behalf of McCombs which could be taken by McCombs himself. In November 1999, Plaintiff Woods, on his own behalf and on behalf of McCombs, agreed to participate in a tax shelter known as COBRA. The evidence shows that COBRA was dreamed up by the law firm of Jenkens & Gilchrist and was being marketed by the accounting firm of Ernst & Young to a few selected high net-worth individuals.

For purposes of this order, it is unnecessary to discuss the details of the COBRA tax avoidance scheme or plan. Suffice it to say that it involved a series of specific steps which, in order to execute the plan, had to be completed by December 31, 1999.

Woods decided to participate in COBRA, on his own behalf and on behalf of McCombs. The steps required by the COBRA plan are described in great detail in the evidence in this case, and there is no need to repeat those details here. Suffice it to say that on November 12, 1999, Woods began the implementation of COBRA plans for himself and McCombs by forming three sets of business entities: two limited liability companies,[6] two general partnerships,[7] and two Sub-

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[6] The names of the LLCs were GW Tesoro Investments, LLC (for Gary Woods) and BJM Tesoro Drive Investments, LLC (for Billy Joe McCombs).

[7] The two partnerships were named Tesoro Drive Partners and

chapter S corporations. Soon after these entities were formed, Woods contributed $791,000.00 to his LLC, and McCombs contributed $2,429,000.00 to his LLC. The very next day, the LLCs invested $2,300,000.00 in thirty-day foreign currency options. Each "long" option on a currency was paired with a "short" option on a different currency.[8] On November 23, 1999, the LLCs transferred the options to the partnerships. The cash remaining in the LLCs was also transferred to the partnerships. Within the next 30 days, each partnership used this cash to purchase shares in Sun Microsystems. On December 15, 1999, one of the partnerships (Tesoro Drive Partners) sold its shares in Sun Micro, resulting in a short-term capital gain of approximately $5,000.00. Tesoro Drive Partners then used its cash to buy Canadian Dollars.

The thirty-day currency options were due to expire on December 20, 1999. However, on December 17, 1999, Deutsche Bank offered Woods $3,000,000.00 for the early termination of the currency option spreads. Woods accepted the offer, resulting in a profit to the partnerships of $700,000.00.[9]

As the year 1999 was coming to a close, both part-

SA Tesoro Investment Partners, and Woods and McCombs were the only partners in both.

[8] Four foreign currencies were utilized: the Australian Dollar, the Japanese Yen, the German Deutsche Mark, and the Swiss Franc.

[9] The specific profit breakdown was Tesoro Drive Partners $650,000.00; SA Tesoro Investment Partners $50,000.00.

nerships transferred all their remaining assets to the two Subchapter S corporations, effectively resulting in the liquidation of the partnerships. One of those Subchapter S corporations, Tesoro Drive Investors, Inc., received the Canadian Dollars, while the other, SA Tesoro Investors, Inc., received the remaining shares in Sun Microsystems. What these entities did next was the whole point of the COBRA strategy. Tesoro Drive Investors, Inc. sold the Canadian Dollars, which Woods and McCombs claimed resulted in an ordinary loss for tax purposes of $13,353,162.00. SA Tesoro Investors, Inc. sold the remaining shares of Sun Microsystems stock, which, according to Woods and McCombs, resulted in a short-term capital loss for tax purposes in the amount of $32,297,786. This treatment was based on the central theory of COBRA, which was that the basis of each partnership's property was the cost of the "long" currency options, while the "short" options could be disregarded for tax purposes.

In the Fifth Circuit, whether a transaction is honored as legitimate for tax purposes requires the Court to determine whether the transaction possesses "economic substance." *Klamath Strategic Investment Fund v. United States*, 568 F.3d 537, 544 (5th Cir. 2009). As the Court of Appeals recently framed the issue in *Klamath*,

> "Thus, if a transaction lacks economic substance compelled by business or regulatory realities, the transaction must be disregarded even if the tax-

payers profess a genuine business purpose without tax avoidance motivations."

Id. It is also clear that the "transaction" which must have economic substance is the transaction that generates the tax benefit, not collateral transactions that do not produce tax benefits. *Klamath*, 568 F.3d at 545; *Coltec Industries, Inc. v. United States*, 454 F.3d 1340, 1356 (Fed. Cir. 2006); *Nicole Rose Corporation v. Commissioner*, 320 F.3d 282, 284 (2nd Cir. 2003). In seeking to detect the presence or the absence of economic substance in the instant case, therefore, the Court cannot focus on those transactions which the taxpayer claims confer economic substance, i.e., profitable trades in currency options and Sun Microsystems stock. These were collateral transactions, which not only did not produce the tax benefit at issue in this case, but did the opposite—they resulted in taxable income to the partnerships. Instead, the "transaction" that is relevant in this case is the Plaintiff's use of two partnerships with a six-week life span to conduct that trading for the sole purpose of generating a paper loss. *See Merryman v. Commissioner*, 873 F.2d 879, 881 (5th Cir. 1989). The "Tinker to Evers to Chance"[10] routine utilized by the taxpayers in this case (the transfer of assets from individuals to LLCs to partnerships to Subchapter S corporations) was not "compelled or encouraged by business or regulatory realities," nor was it "imbued with tax independ-

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[10] The record does not reveal whether the Plaintiff's economic expert, Dr. Don Chance, is related in anyway to first-baseman Chance.

ent considerations." *Frank Lyon Company v. United States*, 435 U.S. 561, 583-84, 98 S. Ct. 1291, 55 L. Ed. 2d 550 (1978). It was totally lacking in economic substance and was for the sole purpose of creating a tax benefit. Therefore, both the ordinary loss and the capital loss claimed by the respective partnerships should be disregarded for tax purposes. The Defendant is entitled to judgment in its favor with respect to the Plaintiff's petition for review of those particular adjustments to the partnership returns.

Still unresolved is the question whether the Internal Revenue Service was justified in imposing certain penalties in addition to the income taxes due and owing as a result of the adjustments. In this connection, the Plaintiff contends that no penalties are justified, relying in part on the defense of reasonable cause and good faith. The Court instructed the Plaintiff to file a brief in support of his position no later than September 27, 2010, and allowed the Defendant until October 7, 2010 to respond. Upon reviewing those briefs, the Court will determine whether additional evidence from either party will be required in connection with the issue of penalties.

It is therefore ORDERED that the Defendant's motion for judgment as a matter of law with respect to the disallowance of the ordinary and capital losses claimed on the partnership returns in this case be, and it is hereby, GRANTED.

It is further ORDERED that Plaintiff Gary Woods file his brief with respect to the issue of penalties no later than September 27, 2010.

It is further ORDERED that the Defendant respond to the Plaintiff's brief no later than October 7, 2010. After reviewing the briefs filed by the parties, the Court will determine whether additional testimony should be taken with respect to this issue.

APPENDIX D

UNITED STATES COURT OF APPEALS
FOR THE FIFTH CIRCUIT

No. 11-50487

GARY WOODS, AS TAX MATTERS PARTNER OF TESORO DRIVE PARTNERS, A TEXAS GENERAL PARTNERSHIP, PLAINTIFF-APPELLEE

v.

UNITED STATES OF AMERICA, DEFENDANT-APPELLANT

[Filed: Aug. 8, 2012]

ON PETITION FOR REHEARING EN BANC

(Opinion: June 6, 2012, 5 Cir., ____, ____, F.3d ____)

Before: JONES, Chief Judge, and WIENER and GRAVES, Circuit Judges.

PER CURIAM:

(✓) Treating the Petition for Rehearing En Banc as a Petition for Panel Rehearing, the Petition for Panel Rehearing is DENIED. No member of the panel nor judge in regular active service of the court having requested that the court be polled on Rehearing En Banc (FED. R. APP. P.

and 5TH CIR. R. 35), the Petition for Rehearing En Banc is DENIED.

( ) Treating the Petition for Rehearing En Banc as a Petition for Panel Rehearing, the Petition for Panel Rehearing is DENIED. The court having been polled at the request of one of the members of the court and a majority of the judges who are in regular active service and not disqualified not having voted in favor (FED. R. APP. P. and 5TH CIR. R. 35), the Petition for Rehearing En Banc is DENIED.

ENTERED FOR THE COURT:

/s/ JAMES E. GRAVES, JR.
JAMES E. GRAVES, JR.
United States Circuit Judge

APPENDIX E

1. 26 U.S.C. 6662 (2000) provides:

Imposition of accuracy-related penalty

(a) Imposition of penalty

If this section applies to any portion of an underpayment of tax required to be shown on a return, there shall be added to the tax an amount equal to 20 percent of the portion of the underpayment to which this section applies.

(b) Portion of underpayment to which section applies

This section shall apply to the portion of any underpayment which is attributable to 1 or more of the following:

(1) Negligence or disregard of rules or regulations.

(2) Any substantial understatement of income tax.

(3) Any substantial valuation misstatement under chapter 1.

(4) Any substantial overstatement of pension liabilities.

(5) Any substantial estate or gift tax valuation understatement.

This section shall not apply to any portion of an underpayment on which a penalty is imposed under section 6663.

(c) Negligence

For purposes of this section, the term "negligence" includes any failure to make a reasonable attempt to comply with the provisions of this title, and the term "disregard" includes any careless, reckless, or intentional disregard.

(d) Substantial understatement of income tax

(1) Substantial understatement

(A) In general

For purposes of this section, there is a substantial understatement of income tax for any taxable year if the amount of the understatement for the taxable year exceeds the greater of—

(i) 10 percent of the tax required to be shown on the return for the taxable year, or

(ii) $5,000.

(B) Special rule for corporations

In the case of a corporation other than an S corporation or a personal holding company (as defined in section 542), paragraph (1) shall be applied by substituting "$10,000" for "$5,000".

(2) Understatement

(A) In general

For purposes of paragraph (1), the term "understatement" means the excess of—

(i) the amount of the tax required to be shown on the return for the taxable year, over

(ii) the amount of the tax imposed which is shown on the return, reduced by any rebate (within the meaning of section 6211(b)(2)).

(B) Reduction for understatement due to position of taxpayer or disclosed item

The amount of the understatement under subparagraph (A) shall be reduced by that portion of the understatement which is attributable to—

(i) the tax treatment of any item by the taxpayer if there is or was substantial authority for such treatment, or

(ii) any item if—

(I) the relevant facts affecting the item's tax treatment are adequately disclosed in the return or in a statement attached to the return, and

(II) there is a reasonable basis for the tax treatment of such item by the taxpayer.

For purposes of clause (ii)(II), in no event shall a corporation be treated as having a reasonable basis for its tax treatment of an item attributable to a multiple-party financing transaction if such treatment does not clearly reflect the income of the corporation.

(C) Special rules in cases involving tax shelters

(i) In general

In the case of any item of a taxpayer other than a corporation which is attributable to a tax shelter—

(I) subparagraph (B)(ii) shall not apply, and

(II) subparagraph (B)(i) shall not apply unless (in addition to meeting the requirements of such subparagraph) the taxpayer reasonably believed that the tax treatment of such item by the taxpayer was more likely than not the proper treatment.

(ii) Subparagraph (B) not to apply to corporations

Subparagraph (B) shall not apply to any item of a corporation which is attributable to a tax shelter.

(iii) Tax shelter

For purposes of this subparagraph, the term "tax shelter" means—

(I) a partnership or other entity,

(II) any investment plan or arrangement, or

(III) any other plan or arrangement,

if a significant purpose of such partnership, entity, plan, or arrangement is the avoidance or evasion of Federal income tax.

(D) Secretarial list

The Secretary shall prescribe (and revise not less frequently than annually) a list of positions—

(i) for which the Secretary believes there is not substantial authority, and

(ii) which affect a significant number of taxpayers.

Such list (and any revision thereof) shall be published in the Federal Register.

(e) Substantial valuation misstatement under chapter 1

(1) In general

For purposes of this section, there is a substantial valuation misstatement under chapter 1 if—

(A) the value of any property (or the adjusted basis of any property) claimed on any return of tax imposed by chapter 1 is 200 percent or more of the amount determined to be the correct amount of such valuation or adjusted basis (as the case may be), or

(B)(i) the price for any property or services (or for the use of property) claimed on any such return in connection with any transaction between persons described in section 482 is 200 percent or more (or 50 percent or less) of the amount determined under section 482 to be the correct amount of such price, or

(ii) the net section 482 transfer price adjustment for the taxable year exceeds the lesser of $5,000,000 or 10 percent of the taxpayer's gross receipts.

(2) Limitation

No penalty shall be imposed by reason of subsection (b)(3) unless the portion of the underpayment for the taxable year attributable to substantial valuation misstatements under chapter 1 exceeds $5,000 ($10,000 in the case of a corpora-

tion other than an S corporation or a personal holding company (as defined in section 542)).

(3) Net section 482 transfer price adjustment

For purposes of this subsection—

(A) In general

The term "net section 482 transfer price adjustment" means, with respect to any taxable year, the net increase in taxable income for the taxable year (determined without regard to any amount carried to such taxable year from another taxable year) resulting from adjustments under section 482 in the price for any property or services (or for the use of property).

(B) Certain adjustments excluded in determining threshold

For purposes of determining whether the threshold requirements of paragraph (1)(B)(ii) are met, the following shall be excluded:

(i) Any portion of the net increase in taxable income referred to in subparagraph (A) which is attributable to any redetermination of a price if—

(I) it is established that the taxpayer determined such price in accordance with a specific pricing method set forth in the regulations prescribed under section 482 and that the taxpayer's use of such method was reasonable,

(II) the taxpayer has documentation (which was in existence as of the time of filing the return) which sets forth the determination of such price in accordance with such a method and which establishes that the use of such method was reasonable, and

(III) the taxpayer provides such documentation to the Secretary within 30 days of a request for such documentation.

(ii) Any portion of the net increase in taxable income referred to in subparagraph (A) which is attributable to a redetermination of price where such price was not determined in accordance with such a specific pricing method if—

(I) the taxpayer establishes that none of such pricing methods was likely to result in a price that would clearly reflect income, the taxpayer used another pricing method to determine such price, and such other pricing method was likely to result in a price that would clearly reflect income,

(II) the taxpayer has documentation (which was in existence as of the time of filing the return) which sets forth the determination of such price in accordance with such other method and which establishes that the requirements of subclause (I) were satisfied, and

(III) the taxpayer provides such documentation to the Secretary within 30 days of request for such documentation.

(iii) Any portion of such net increase which is attributable to any transaction solely between foreign corporations unless, in the case of any such corporations, the treatment of such transaction affects the determination of income from sources within the United States or taxable income effectively connected with the conduct of a trade or business within the United States.

(C) Special rule

If the regular tax (as defined in section 55(c)) imposed by chapter 1 on the taxpayer is determined by reference to an amount other than taxable income, such amount shall be treated as the taxable income of such taxpayer for purposes of this paragraph.

(D) Coordination with reasonable cause exception

For purposes of section 6664(c) the taxpayer shall not be treated as having reasonable cause for any portion of an underpayment attributable to a net section 482 transfer price adjustment unless such taxpayer meets the requirements of clause (i), (ii), or (iii) of subparagraph (B) with respect to such portion.

(f) Substantial overstatement of pension liabilities

(1) In general

For purposes of this section, there is a substantial overstatement of pension liabilities if the actuarial determination of the liabilities taken into account for purposes of computing the deduction under paragraph (1) or (2) of section 404(a) is 200 percent or more of the amount determined to be the correct amount of such liabilities.

(2) Limitation

No penalty shall be imposed by reason of subsection (b)(4) unless the portion of the underpayment for the taxable year attributable to substantial overstatements of pension liabilities exceeds $1,000.

(g) Substantial estate or gift tax valuation understatement

(1) In general

For purposes of this section, there is a substantial estate or gift tax valuation understatement if the value of any property claimed on any return of tax imposed by subtitle B is 50 percent or less of the amount determined to be the correct amount of such valuation.

(2) Limitation

No penalty shall be imposed by reason of subsection (b)(5) unless the portion of the underpayment attributable to substantial estate or gift tax valuation understatements for the taxable period (or, in

the case of the tax imposed by chapter 11, with respect to the estate of the decedent) exceeds $5,000.

(h) Increase in penalty in case of gross valuation misstatements

(1) In general

To the extent that a portion of the underpayment to which this section applies is attributable to one or more gross valuation misstatements, subsection (a) shall be applied with respect to such portion by substituting "40 percent" for "20 percent".

(2) Gross valuation misstatements

The term "gross valuation misstatements" means—

(A) any substantial valuation misstatement under chapter 1 as determined under subsection (e) by substituting—

(i) "400 percent" for "200 percent" each place it appears,

(ii) "25 percent" for "50 percent", and

(iii) in paragraph (1)(B)(ii)—

(I) "$20,000,000" for "$5,000,000", and

(II) "20 percent" for "10 percent".

(B) any substantial overstatement of pension liabilities as determined under subsection (f) by substituting "400 percent" for "200 percent", and

(C) any substantial estate or gift tax valuation understatement as determined under subsection (g) by substituting "25 percent" for "50 percent".

2. 26 C.F.R. 1.6662-5 provides:

Substantial and gross valuation misstatements under chapter 1.

(a) *In general.* If any portion of an underpayment, as defined in section 6664(a) and §1.6664-2, of any income tax imposed under chapter 1 of subtitle A of the Code that is required to be shown on a return is attributable to a substantial valuation misstatement under chapter 1 ("substantial valuation misstatement"), there is added to the tax an amount equal to 20 percent of such portion. Section 6662(h) increases the penalty to 40 percent in the case of a gross valuation misstatement under chapter 1 ("gross valuation misstatement"). No penalty under section 6662(b)(3) is imposed, however, on a portion of an underpayment that is attributable to a substantial or gross valuation misstatement unless the aggregate of all portions of the underpayment attributable to substantial or gross valuation misstatements exceeds the applicable dollar limitation ($5,000 or $10,000), as provided in section 6662(e)(2) and paragraphs (b) and (f)(2) of this section. This penalty also does not apply to the extent that the reasonable cause and good faith exception to this penalty set forth in § 1.6664-4 applies. There is no disclosure exception to this penalty.

(b) *Dollar limitation.* No penalty may be imposed under section 6662(b)(3) for a taxable year unless the portion of the underpayment for that year that is attributable to substantial or gross valuation misstatements exceeds $5,000 ($10,000 in the case of a corporation other than an S corporation (as defined in section 1361(a)(1)) or a personal holding company (as defined in section 542)). This limitation is applied separately to each taxable year for which there is a substantial or gross valuation misstatement.

(c) *Special rules in the case of carrybacks and carryovers*—(1) *In general.* The penalty for a substantial or gross valuation misstatement applies to any portion of an underpayment for a year to which a loss, deduction or credit is carried that is attributable to a substantial or gross valuation misstatement for the year in which the carryback or carryover of the loss, deduction or credit arises (the "loss or credit year"), provided that the applicable dollar limitation set forth in section 6662(e)(2) is satisfied in the carryback or carryover year.

(2) *Transition rule for carrybacks to pre-1990 years.* The penalty under section 6662(b)(3) is imposed on any portion of an underpayment for a carryback year, the return for which is due (without regard to extensions) before January 1, 1990, if—

(i) That portion is attributable to a substantial or gross valuation misstatement for a loss or credit year; and

(ii) The return for the loss or credit year is due (without regard to extensions) after December 31, 1989.

The preceding sentence applies only if the underpayment for the carryback year exceeds the applicable dollar limitation ($5,000, or $10,000 for most corporations). See *Example 3* in paragraph (d) of this section.

(d) *Examples.* The following examples illustrate the provisions of paragraphs (b) and (c) of this section. These examples do not take into account the reasonable cause exception under §1.6664-4.

Example 1. Corporation Q is a C corporation. In 1990, the first year of its existence, Q had taxable income of $200,000 without considering depreciation of a particular asset. On its calendar year 1990 return, Q overstated its basis in this asset by an amount that caused a substantial valuation misstatement. The overstated basis resulted in depreciation claimed of $350,000, which was $250,000 more than the $100,000 allowable. Thus, on its 1990 return, Q showed a loss of $150,000. In 1991, Q had taxable income of $450,000 before application of the loss carryover, and Q claimed a carryover loss deduction under section 172 of $150,000, resulting in taxable income of $300,000 for 1991. Upon audit of the 1990 return, the basis of the asset was corrected, resulting in an adjustment of $250,000. For 1990, the underpayment resulting from the $100,000 taxable income (-$150,000+$250,000) is attributable to the valuation misstatement. Assuming the underpayment resulting from the $100,000

taxable income exceeds the $10,000 limitation, the penalty will be imposed in 1990. For 1991, the elimination of the loss carryover results in additional taxable income of $150,000. The underpayment for 1991 resulting from that adjustment is also attributable to the substantial valuation misstatement on the 1990 return. Assuming the underpayment resulting from the $150,000 additional taxable income for 1991 exceeds the $10,000 limitation, the substantial valuation misstatement penalty also will be imposed for that year.

Example 2. (i) Corporation T is a C corporation. In 1990, the first year of its existence, T had a loss of $3,000,000 without considering depreciation of its major asset. On its calendar year 1990 return, T overstated its basis in this asset in an amount that caused a substantial valuation misstatement. This overstatement resulted in depreciation claimed of $3,500,000, which was $2,500,000 more than the $1,000,000 allowable. Thus, on its 1990 return, T showed a loss of $6,500,000. In 1991, T had taxable income of $4,500,000 before application of the carryover loss, but claimed a carryover loss deduction under section 172 in the amount of $4,500,000, resulting in taxable income of zero for that year and leaving a $2,000,000 carryover available. Upon audit of the 1990 return, the basis of the asset was corrected, resulting in an adjustment of $2,500,000.

(ii) For 1990, the underpayment is still zero (-$6,500,000+$2,500,000=-$4,000,000). Thus, the pen-

alty does not apply in 1990. The loss for 1990 is reduced to $4,000,000.

(iii) For 1991, there is additional taxable income of $500,000 as a result of the reduction of the carryover loss ($4,500,000 reported income before carryover loss minus corrected carryover loss of $4,000,000= $500,000). The underpayment for 1991 resulting from reduction of the carryover loss is attributable to the valuation misstatement on the 1990 return. Assuming the underpayment resulting from the $500,000 additional taxable income exceeds the $10,000 limitation, the substantial valuation misstatement penalty will be imposed in 1991.

Example 3. Corporation V is a C corporation. In 1990, V had a loss of $100,000 without considering depreciation of a particular asset which it had fully depreciated in earlier years. V had a depreciable basis in the asset of zero, but on its 1990 calendar year return erroneously claimed a basis in the asset of $1,250,000 and depreciation of $250,000. V reported a $350,000 loss for the year 1990, and carried back the loss to the 1987 and 1988 tax years. V had reported taxable income of $300,000 in 1987 and $200,000 in 1988, before application of the carryback. The $350,000 carryback eliminated all taxable income for 1987, and $50,000 of the taxable income for 1988. After disallowance of the $250,000 depreciation deduction for 1990, V still had a loss of $100,000. Because there is no underpayment for 1990, no valuation misstatement penalty is imposed for 1990. However, as a result of the 1990 depreciation adjustment, the carry-

back to 1987 is reduced from $350,000 to $100,000. After absorption of the $100,000 carryback, V has taxable income of $200,000 for 1987. This adjustment results in an underpayment for 1987 that is attributable to the valuation misstatement on the 1990 return. The valuation misstatement for 1990 is a gross valuation misstatement because the correct adjusted basis of the depreciated asset was zero. (See paragraph (e)(2) of this section.) Therefore, the 40 percent penalty rate applies to the 1987 underpayment attributable to the 1990 misstatement, provided that this underpayment exceeds $10,000. The adjustment also results in the elimination of any loss carryback to 1988 resulting in an increase in taxable income for 1988 of $50,000. Assuming the underpayment resulting from this additional $50,000 of income exceeds $10,000, the gross valuation misstatement penalty is imposed on the underpayment for 1988.

(e) *Definitions*—(1) *Substantial valuation misstatement.* There is a substantial valuation misstatement if the value or adjusted basis of any property claimed on a return of tax imposed under chapter 1 is 200 percent or more of the correct amount.

(2) *Gross valuation misstatement.* There is a gross valuation misstatement if the value or adjusted basis of any property claimed on a return of tax imposed under chapter 1 is 400 percent or more of the correct amount.

(3) *Property.* For purposes of this section, the term "property" refers to both tangible and intangible property. Tangible property includes property such

as land, buildings, fixtures and inventory. Intangible property includes property such as goodwill, covenants not to compete, leaseholds, patents, contract rights, debts and choses in action.

(f) *Multiple valuation misstatements on a return*—(1) *Determination of whether valuation misstatements are substantial or gross.* The determination of whether there is a substantial or gross valuation misstatement on a return is made on a property-by-property basis. Assume, for example, that property A has a value of 60 but a taxpayer claims a value of 110, and that property B has a value of 40 but the taxpayer claims a value of 100. Because the claimed and correct values are compared on a property-by-property basis, there is a substantial valuation misstatement with respect to property B, but not with respect to property A, even though the claimed values (210) are 200 percent or more of the correct values (100) when compared on an aggregate basis.

(2) *Application of dollar limitation.* For purposes of applying the dollar limitation set forth in section 6662(e)(2), the determination of the portion of an underpayment that is attributable to a substantial or gross valuation misstatement is made by aggregating all portions of the underpayment attributable to substantial or gross valuation misstatements. Assume, for example, that the value claimed for property C on a return is 250 percent of the correct value, and that the value claimed for property D on the return is 400 percent of the correct value. Because the portions of an underpayment that are attributable to a substantial or

gross valuation misstatement on a return are aggregated in applying the dollar limitation, the dollar limitation is satisfied if the portion of the underpayment that is attributable to the misstatement of the value of property C, when aggregated with the portion of the underpayment that is attributable to the misstatement of the value of property D, exceeds $5,000 ($10,000 in the case of most corporations).

(g) *Property with a value or adjusted basis of zero.* The value or adjusted basis claimed on a return of any property with a correct value or adjusted basis of zero is considered to be 400 percent or more of the correct amount. There is a gross valuation misstatement with respect to such property, therefore, and the applicable penalty rate is 40 percent.

(h) *Pass-through entities*—(1) *In general.* The determination of whether there is a substantial or gross valuation misstatement in the case of a return of a pass-through entity (as defined in §1.6662-4(f)(5)) is made at the entity level. However, the dollar limitation ($5,000 or $10,000, as the case may be) is applied at the taxpayer level *(i.e.*, with respect to the return of the shareholder, partner, beneficiary, or holder of a residual interest in a REMIC).

(2) *Example.* The rules of paragraph (h)(1) of this section may be illustrated by the following example.

Example. Partnership P has two partners, individuals A and B. P claims a $40,000 basis in a depreciable asset which, in fact, has a basis of $15,000. The determination that there is a substantial valuation mis-

statement is made solely with reference to P by comparing the $40,000 basis claimed by P with P's correct basis of $15,000. However, the determination of whether the $5,000 threshold for application of the penalty has been reached is made separately for each partner. With respect to partner A, the penalty will apply if the portion of A's underpayment attributable to the pass-through of the depreciation deduction, when aggregated with any other portions of A's underpayment also attributable to substantial or gross valuation misstatements, exceeds $5,000 (assuming there is not reasonable cause for the misstatements (*see* §1.6664-4(c)).

(i) [Reserved]

(j) *Transactions between persons described in section 482 and net section 482 transfer price adjustments.* [Reserved]

(k) *Returns affected.* Except in the case of rules relating to transactions between persons described in section 482 and net sections 482 transfer price adjustments, the provisions of section 6662(b)(3) apply to returns due (without regard to extensions of time to file) after December 31, 1989, notwithstanding that the original substantial or gross valuation misstatement occurred on a return that was due (without regard to extensions) before January 1, 1990. Assume, for example, that a calendar year corporation claimed a deduction on its 1990 return for depreciation of an asset with a basis of X. Also assume that it had reported the same basis for computing depreciation on its returns for the preceding 5 years and that the basis shown on the return each year was 200 percent or

more of the correct basis. The corporation may be subject to a penalty for substantial valuation misstatements on its 1989 and 1990 returns, even though the original misstatement occurred prior to the effective date of sections 6662(b)(3) and (e).

OPPOSITION BRIEF

SUPREME COURT, U.S.
FILED
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No. 12-562

In the Supreme Court of the United States

UNITED STATES,

Petitioner,

v.

GARY WOODS, AS TAX MATTERS PARTNER OF TESORO DRIVE PARTNERS, ET AL.,

Respondents.

On Petition for Writ of Certiorari to the United States Court of Appeals for the Fifth Circuit

BRIEF IN OPPOSITION

JOEL N. CROUCH
Counsel of Record
MEADOWS, COLLIER, REED, COUSINS, CROUCH & UNGERMAN L.L.P.
901 Main Street, Suite 3700
Dallas, Texas 75202
(214) 744-3700
jcrouch@meadowscollier.com

Counsel for Respondents

Becker Gallagher · Cincinnati, OH · Washington, D.C. · 800.890.5001

QUESTION PRESENTED

Whether the 40% gross valuation misstatement penalty applies to an underpayment of tax resulting from a determination that a transaction lacks economic substance.

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STATUTORY AND REGULATORY PROVISIONS INVOLVED

Petitioner has included all pertinent statutory and regulatory provisions at *Pet. App.* 25a-44a, with the exceptions of the current version of Section 6662 of the Internal Revenue Code and Section 1409 of the Health Care and Education Reconciliation Act of 2010, Pub. Law No. 111-152, 124 Stat. 1029, 1067, both of which are reprinted in Appendix 1.

STATEMENT

In 1999, Gary Woods ("Woods"), on behalf of himself and his business associate, Billy Joe "Red" McCombs ("McCombs"), participated in a strategy known as "COBRA" on the advice of Ernst & Young and other prominent tax advisors. *Pet. App.* 16a-17a. Pursuant to such advice, two COBRA transactions were implemented: one transaction through Tesoro Drive Partners ("TDP"), a Texas general partnership and one transaction through SA Tesoro Investment Partners ("SATIP"), also a Texas general partnership.

In December 2004, the IRS issued Final Notices of Partnership Administrative Adjustment ("FPAAs") to TDP and SATIP. The FPAAs proposed to disallow in full the COBRA transactions for various reasons, including that the transactions lacked economic substance. The FPAAs also proposed accuracy-related penalties under Section 6662(a) of the Internal Revenue Code, including the 40% gross valuation misstatement penalty at issue.

Woods, as Tax Matters Partner of both TDP and SATIP, filed actions in the United States District Court for the Western District of Texas challenging the FPAAs. After Woods presented his case in chief at trial, the District Court granted the Government's motion for judgment as a matter of law. *Pet. App.* 15a, 16a. The District Court found that the COBRA transactions were lacking in economic substance and that the losses should be disregarded for tax purposes. *Pet. App.* 21a. In a subsequent order, the District Court ruled that the transactions in question were subject to a 20% accuracy-related penalty under Section 6662. *Pet. App.* 9a, 13a; *see also* 26 U.S.C. § 6662(a),(b)(1),(2); 26 C.F.R. § 1.6662-2(c). The taxpayers do not challenge this ruling.

The District Court also ruled that the 40% gross valuation misstatement penalty did not apply under controlling Fifth Circuit precedent. *Pet. App.* 6a. The Government appealed this ruling, and the Court of Appeals for the Fifth Circuit affirmed applying long-standing circuit precedent. *Pet. App.* 2a; *Todd v. Comm'r*, 862 F.2d 540 (5th Cir. 1988).

SUMMARY ARGUMENT

This case presents an obsolete issue: whether a 40% penalty applies when the tax underpayment is attributable to a transaction that lacks economic substance. Congress resolved this issue in 2010, statutorily imposing a 40% penalty in these circumstances. The outcome of this case—limiting the penalty to 20% where a determination is made that a transaction lacks economic substance—cannot occur under current law. On a going forward basis, Congress

has fully reconciled the circuit court differences identified by the Government. Further, even as a historical matter, the issue presented is unimportant, which is underscored by the Court's decision last term in *United States v. Home Concrete & Supply LLC*, 566 U.S. ----,132 S. Ct. 1836, 182 L. Ed. 746 (2012), reinforcing the three year statute of limitations in transactions involving an alleged overstatement of basis. The petition for writ of certiorari should therefore be denied.

ARGUMENT

1. The Court Should Deny the Petition Because Whether a 40% Penalty Applies to a Transaction that Lacks Economic Substance is an Obsolete Issue in Light of Congressional Action in 2010.

The Government presents to this Court a narrow and limited question: whether the 40% penalty "applies to an underpayment resulting from a determination that a transaction lacks economic substance because the sole purpose of the transaction was to generate a tax loss by artificially inflating the taxpayer's basis in property." *Pet.* (I). Congress answered this precise question in the affirmative with the 2010 addition of subsection (i) to section 6662 of the Internal Revenue Code. *See* Health Care and Education Reconciliation Act of 2010, Pub. Law No. 111-152, § 1409(b)(2), 124 Stat. 1029, 1069 (effective for transactions entered into after Mar. 30, 2010).

Section 6662(i) imposes a 40% penalty on any portion of an underpayment attributable to a "nondisclosed noneconomic substance transaction." 26 U.S.C. § 6662(i)(1). A transaction is treated as having economic substance "only if the transaction changes in a meaningful way (apart from Federal income tax effects) the taxpayer's economic position, and the taxpayer has a substantial purpose (apart from Federal income tax effects) for entering into such transaction." *See id.* §§ 6662(b)(6),(i)(2), §7701(o)(1). A transaction is nondisclosed if "the relevant facts affecting the tax treatment are not adequately disclosed in a return nor in a statement attached to the return." *See id.* § 6662(i)(2).

The COBRA transaction in this case would undisputedly be subject to this 40% penalty regime established by Section 6662(i). The District Court found that the transaction "was totally lacking in economic substance and was for the sole purpose of creating a tax benefit." *Pet. App.* 21a. Further, none of the taxpayers at issue filed a Form 8275 Disclosure Statement with the IRS disclosing the relevant facts affecting the tax treatment of the transactions.[1] Thus for COBRA and similar transactions entered into after March 30, 2010, the issue presented by this case is obsolete. A 40% penalty would apply under Section 6662(i) regardless of whether the tax underpayment

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[1] IRS Notice 2010-62 (Sept. 13, 2010) ("The disclosure will be considered adequate only if it is made on a Form 8275 or 8275-R, or as otherwise prescribed in forms, publications, or other guidance subsequently published by the IRS").

was also attributable to an item giving rise to a gross valuation misstatement.

In effect, Section 6662(i) has eliminated any arguable importance the issue in this case might have possessed. Even the Government acknowledges that Section 6662(i) would impose a 40% penalty in cases, such as this case, where the tax underpayment is attributable to a transaction that lacks economic substance. *Pet.* 31. The enactment of Section 6662(i) has further eliminated any practical significance of the disagreement among the circuits identified by the Government. Going forward, the Fifth and Ninth Circuits must follow Section 6662(i). For this reason, the petition for writ of certiorari should be denied.

2. The Court Should Deny the Petition Because the Imposition of the 40% Penalty in Cases Where the 20% Penalty Applies is Not an Important Matter.

The historical disagreement among the circuits on the application of the 40% valuation misstatement penalty simply does not warrant this Court's review.

The issue is extremely narrow. As discussed, Congress has resolved this issue for all transactions since 2010. And even for those transactions before 2010, what is ultimately at stake is the *amount* of penalty that will be assessed—not *whether* a penalty will be assessed. In essence, the question the Government seeks to bring before the Court is whether Woods and McCombs, currently subject to a 20% penalty, should instead face a 40% penalty. This is not a question of any great importance.

The issue also has limited applicability. The Government contends that under the Fifth and Ninth Circuit's interpretation of the valuation misstatement penalty, "the federal government will be deprived of substantial revenue that is owed by wealthy individuals or companies that attempted to avoid their tax obligations by participating in abusive tax shelters." *Pet.* 30. The Government does not claim, nor can it truthfully claim, that the issue affects all taxpayers or even most taxpayers. It freely admits that the issue only affects a select few high net-worth taxpayers that were approached by the Top Four Accounting Firms with a sophisticated tax strategy during a brief period ending in the early 2000s. *See Pet. App.* 5a. Moreover, the Government offers no support for its sensationalized claim that the issue is costing "the federal fisc hundreds of millions of dollars in forgone penalties . . . ." *Pet.* 29.

Any arguable importance of this issue for transactions before 2010 is significantly diminished by the three-year statute of limitations in 26 U.S.C. § 6501(a). This Court reaffirmed last term in *United States v. Home Concrete & Supply LLC*, 566 U.S. ---, 132 S. Ct. 1836, 182 L. Ed. 746 (2012), that the limitations period in Section 6501(a) generally applies in cases involving deficiencies arising from an overstatement of basis, including decisions based on a finding that a transaction lacks economic substance. As the Government effectively recognized in asking this Court to grant certiorari in *Home Concrete*, the Government's position that the six-year period applied was key to its efforts to pursue certain transactions (including COBRA transactions) that became prevalent in the late 1990s and 2000s. *See* Br. for the

Respondent, *Beard v. Comm'r*, No. 10-1553, at 20 (recommending certiorari). The Court's decision in *Home Concrete* – which rejected the Government's position – significantly reduces the number of cases in which the resolution of the circuit disagreement identified by the Government could matter.

The reality is that the disagreement among the circuits on this narrow issue of a 40% versus a 20% penalty is not an important matter. Accordingly, the Court should deny the petition for writ of certiorari.

CONCLUSION

At the end of the day, the Government ultimately is asking this Court for error correction in a case in which the taxpayers already have been assessed a 20% penalty, in order to resolve an issue that Congress has definitively addressed for any transaction arising in 2010 or later. Moreover, the Government's claim that this Court's intervention is needed is further undercut by the fact that the circuit differences identified by the Government have existed for nearly 25 years (since the Fifth Circuit's decision in *Todd*). Yet, there is no evidence that the IRS's enforcement efforts have been materially impacted during that period – even in the Fifth Circuit itself. That presumably explains why the Government never previously petitioned for writ of certiorari on this issue, even before the enactment of Section 6662(i), which resolves the issue. Especially in the wake of Section 6662(i), there is no need for the Court to devote its scarce resources to this issue now. The petition for writ of certiorari should be denied.

Respectfully submitted,

Joel N. Crouch
Counsel of Record
Meadows, Collier, Reed, Cousins,
Crouch & Ungerman, L.L.P.
901 Main Street, Suite 3700
Dallas, Texas 75202
(214) 744-3700
jcrouch@medowscollier.com

Counsel for Respondents

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APPENDIX 1

26 U.S.C. § 6662 (2011)

Imposition of accuracy-related penalty on underpayments

(a) **Imposition of penalty.**--If this section applies to any portion of an underpayment of tax required to be shown on a return, there shall be added to the tax an amount equal to 20 percent of the portion of the underpayment to which this section applies.

(b) **Portion of underpayment to which section applies.**--This section shall apply to the portion of any underpayment which is attributable to 1 or more of the following:

(1) Negligence or disregard of rules or regulations.

(2) Any substantial understatement of income tax.

(3) Any substantial valuation misstatement under chapter 1.

(4) Any substantial overstatement of pension liabilities.

(5) Any substantial estate or gift tax valuation understatement.

(6) Any disallowance of claimed tax benefits by

reason of a transaction lacking economic substance (within the meaning of section 7701(o)) or failing to meet the requirements of any similar rule of law.

(7) Any undisclosed foreign financial asset understatement.

This section shall not apply to any portion of an underpayment on which a penalty is imposed under section 6663. Except as provided in paragraph (1) or (2)(B) of section 6662A(e), this section shall not apply to the portion of any underpayment which is attributable to a reportable transaction understatement on which a penalty is imposed under section 6662A.

(c) **Negligence.**--For purposes of this section, the term "negligence" includes any failure to make a reasonable attempt to comply with the provisions of this title, and the term "disregard" includes any careless, reckless, or intentional disregard.

(d) **Substantial understatement of income tax.--**

(1) **Substantial understatement.--**

(A) **In general.**--For purposes of this section, there is a substantial understatement of income tax for any taxable year if the amount of the understatement for the taxable year exceeds the greater of--

(i) 10 percent of the tax required to be shown on the return for the taxable year, or

(ii) $5,000.

(B) **Special rule for corporations.**--In the case of a corporation other than an S corporation or a personal holding company (as defined in section 542), there is a substantial understatement of income tax for any taxable year if the amount of the understatement for the taxable year exceeds the lesser of--

(i) 10 percent of the tax required to be shown on the return for the taxable year (or, if greater, $10,000), or

(ii) $10,000,000.

(2) Understatement.--

(A) **In general.**--For purposes of paragraph (1), the term "understatement" means the excess of--

(i) the amount of the tax required to be shown on the return for the taxable year, over

(ii) the amount of the tax imposed which is shown on the return, reduced by any rebate (within the meaning of section 6211(b)(2)). The

excess under the preceding sentence shall be determined without regard to items to which section 6662A applies.

(B) **Reduction for understatement due to position of taxpayer or disclosed item.**--The amount of the understatement under subparagraph (A) shall be reduced by that portion of the understatement which is attributable to--

(i) the tax treatment of any item by the taxpayer if there is or was substantial authority for such treatment, or

(ii) any item if--

(I) the relevant facts affecting the item's tax treatment are adequately disclosed in the return or in a statement attached to the return, and

(II) there is a reasonable basis for the tax treatment of such item by the taxpayer.

For purposes of clause (ii)(II), in no event shall a corporation be treated as having a reasonable basis for its tax treatment of an item attributable to a multiple-party financing transaction if such

treatment does not clearly reflect the income of the corporation.

(C) **Reduction not to apply to tax shelters.--**

(i) **In general.**--Subparagraph (B) shall not apply to any item attributable to a tax shelter.

(ii) **Tax shelter.**--For purposes of clause (i), the term "tax shelter" means--

(I) a partnership or other entity,

(II) any investment plan or arrangement, or

(III) any other plan or arrangement,

if a significant purpose of such partnership, entity, plan, or arrangement is the avoidance or evasion of Federal income tax.

(3) **Secretarial list.**--The Secretary may prescribe a list of positions which the Secretary believes do not meet 1 or more of the standards specified in paragraph (2)(B)(i), section 6664(d)(2), and section 6694(a)(1). Such list (and any revisions thereof) shall be published in the Federal Register or the Internal Revenue Bulletin.

(e) **Substantial valuation misstatement under chapter 1.--**

(1) **In general.**--For purposes of this section, there

is a substantial valuation misstatement under chapter 1 if--

(A) the value of any property (or the adjusted basis of any property) claimed on any return of tax imposed by chapter 1 is 150 percent or more of the amount determined to be the correct amount of such valuation or adjusted basis (as the case may be), or

(B)(i) the price for any property or services (or for the use of property) claimed on any such return in connection with any transaction between persons described in section 482 is 200 percent or more (or 50 percent or less) of the amount determined under section 482 to be the correct amount of such price, or

(ii) the net section 482 transfer price adjustment for the taxable year exceeds the lesser of $5,000,000 or 10 percent of the taxpayer's gross receipts.

(2) **Limitation.**--No penalty shall be imposed by reason of subsection (b)(3) unless the portion of the underpayment for the taxable year attributable to substantial valuation misstatements under chapter 1 exceeds $5,000 ($10,000 in the case of a corporation other than an S corporation or a personal holding company (as defined in section 542)).

(3) Net section 482 transfer price adjustment.--For purposes of this subsection--

(A) In general.--The term "net section 482 transfer price adjustment" means, with respect to any taxable year, the net increase in taxable income for the taxable year (determined without regard to any amount carried to such taxable year from another taxable year) resulting from adjustments under section 482 in the price for any property or services (or for the use of property).

(B) Certain adjustments excluded in determining threshold.--For purposes of determining whether the threshold requirements of paragraph (1)(B)(ii) are met, the following shall be excluded:

(i) Any portion of the net increase in taxable income referred to in subparagraph (A) which is attributable to any redetermination of a price if--

(I) it is established that the taxpayer determined such price in accordance with a specific pricing method set forth in the regulations prescribed under section 482 and that the taxpayer's use of such method was reasonable,

(II) the taxpayer has documentation (which was in existence as of the time of filing the return) which sets forth the determination of such price in accordance with such a method and which establishes that the use of such method was reasonable, and

(III) the taxpayer provides such documentation to the Secretary within 30 days of a request for such documentation.

(ii) Any portion of the net increase in taxable income referred to in subparagraph (A) which is attributable to a redetermination of price where such price was not determined in accordance with such a specific pricing method if--

(I) the taxpayer establishes that none of such pricing methods was likely to result in a price that would clearly reflect income, the taxpayer used another pricing method to determine such price, and such other pricing method was likely to result in a price that would clearly reflect income,

(II) the taxpayer has documentation (which was in

existence as of the time of filing the return) which sets forth the determination of such price in accordance with such other method and which establishes that the requirements of subclause (I) were satisfied, and

(III) the taxpayer provides such documentation to the Secretary within 30 days of request for such documentation.

(iii) Any portion of such net increase which is attributable to any transaction solely between foreign corporations unless, in the case of any such corporations, the treatment of such transaction affects the determination of income from sources within the United States or taxable income effectively connected with the conduct of a trade or business within the United States.

(C) **Special rule.**--If the regular tax (as defined in section 55(c)) imposed by chapter 1 on the taxpayer is determined by reference to an amount other than taxable income, such amount shall be treated as the taxable income of such taxpayer for purposes of this paragraph.

(D) **Coordination with reasonable cause exception.**--For purposes of section 6664(c) the taxpayer shall not be treated as having reasonable cause for any portion of an underpayment attributable to a net section 482 transfer price adjustment unless such taxpayer meets the requirements of clause (i), (ii), or (iii) of subparagraph (B) with respect to such portion.

(f) **Substantial overstatement of pension liabilities.--**

(1) **In general.**--For purposes of this section, there is a substantial overstatement of pension liabilities if the actuarial determination of the liabilities taken into account for purposes of computing the deduction under paragraph (1) or (2) of section 404(a) is 200 percent or more of the amount determined to be the correct amount of such liabilities.

(2) **Limitation.**--No penalty shall be imposed by reason of subsection (b)(4) unless the portion of the underpayment for the taxable year attributable to substantial overstatements of pension liabilities exceeds $1,000.

(g) **Substantial estate or gift tax valuation understatement.--**

(1) **In general.**--For purposes of this section, there is a substantial estate or gift tax valuation understatement if the value of any property

claimed on any return of tax imposed by subtitle B is 65 percent or less of the amount determined to be the correct amount of such valuation.

(2) **Limitation.**--No penalty shall be imposed by reason of subsection (b)(5) unless the portion of the underpayment attributable to substantial estate or gift tax valuation understatements for the taxable period (or, in the case of the tax imposed by chapter 11, with respect to the estate of the decedent) exceeds $5,000.

(h) Increase in penalty in case of gross valuation misstatements.--

(1) **In general.**--To the extent that a portion of the underpayment to which this section applies is attributable to one or more gross valuation misstatements, subsection (a) shall be applied with respect to such portion by substituting "40 percent" for "20 percent".

(2) **Gross valuation misstatements.**--The term "gross valuation misstatements" means--

(A) any substantial valuation misstatement under chapter 1 as determined under subsection (e) by substituting--

(i) in paragraph (1)(A), "200 percent" for "150 percent",

(ii) in paragraph (1)(B)(i)--

(I) "400 percent" for "200 percent",

and

(II) "25 percent" for "50 percent", and

(iii) in paragraph (1)(B)(ii)--

(I) "$20,000,000" for "$5,000,000", and

(II) "20 percent" for "10 percent".

(B) any substantial overstatement of pension liabilities as determined under subsection (f) by substituting "400 percent" for "200 percent", and

(C) any substantial estate or gift tax valuation understatement as determined under subsection (g) by substituting "40 percent" for "65 percent".

(i) Increase in penalty in case of nondisclosed noneconomic substance transactions.--

(1) In general.--In the case of any portion of an underpayment which is attributable to one or more nondisclosed noneconomic substance transactions, subsection (a) shall be applied with respect to such portion by substituting "40 percent" for "20 percent".

(2) Nondisclosed noneconomic substance transactions.--For purposes of this subsection, the term "nondisclosed noneconomic substance transaction" means any portion of a transaction described in subsection (b)(6) with respect to

which the relevant facts affecting the tax treatment are not adequately disclosed in the return nor in a statement attached to the return.

(3) **Special rule for amended returns.**--In no event shall any amendment or supplement to a return of tax be taken into account for purposes of this subsection if the amendment or supplement is filed after the earlier of the date the taxpayer is first contacted by the Secretary regarding the examination of the return or such other date as is specified by the Secretary.

(j) **Undisclosed foreign financial asset understatement.--**

(1) **In general.**--For purposes of this section, the term "undisclosed foreign financial asset understatement" means, for any taxable year, the portion of the understatement for such taxable year which is attributable to any transaction involving an undisclosed foreign financial asset.

(2) **Undisclosed foreign financial asset.**--For purposes of this subsection, the term "undisclosed foreign financial asset" means, with respect to any taxable year, any asset with respect to which information was required to be provided under section 6038, 6038B, 6038D, 6046A, or 6048 for such taxable year but was not provided by the taxpayer as required under the provisions of those sections.

(3) Increase in penalty for undisclosed foreign financial asset understatements.--In the case of any portion of an underpayment which is attributable to any undisclosed foreign financial asset understatement, subsection (a) shall be applied with respect to such portion by substituting "40 percent" for "20 percent".

Health Care and Education Reconciliation Act of 2010, Pub. Law No. 111-152, §1409, 124 Stat. 1029, 1067

SEC. 1409. CODIFICATION OF ECONOMIC SUBSTANCE DOCTRINE AND PENALTIES.

(a) IN GENERAL.—Section 7701 of the Internal Revenue Code of 1986 is amended by redesignating subsection (o) as subsection (p) and by inserting after subsection (n) the following new subsection:

> **"(o) CLARIFICATION OF ECONOMIC SUBSTANCE DOCTRINE.—**
>
> > **"(1) APPLICATION OF DOCTRINE.**—In the case of any transaction to which the economic substance doctrine is relevant, such transaction shall be treated as having economic substance only if—
> >
> > > **"(A)** the transaction changes in a meaningful way (apart from Federal income tax effects) the taxpayer's economic position, and
> > >
> > > **"(B)** the taxpayer has a substantial purpose (apart from Federal income tax effects) for entering into such transaction.
> >
> > **"(2) SPECIAL RULE WHERE TAXPAYER RELIES ON PROFIT POTENTIAL.—**
> >
> > > **"(A) IN GENERAL.**—The potential for profit of a transaction shall be taken into account in determining whether the

requirements of subparagraphs (A) and (B) of paragraph (1) are met with respect to the transaction only if the present value of the reasonably expected pre-tax profit from the transaction is substantial in relation to the present value of the expected net tax benefits that would be allowed if the transaction were respected.

"(B) **TREATMENT OF FEES AND FOREIGN TAXES.**—Fees and other transaction expenses shall be taken into account as expenses in determining pre-tax profit under subparagraph (A). The Secretary shall issue regulations requiring foreign taxes to be treated as expenses in determining pre-tax profit in appropriate cases.

"(3) **STATE AND LOCAL TAX BENEFITS.**—For purposes of paragraph (1), any State or local income tax effect which is related to a Federal income tax effect shall be treated in the same manner as a Federal income tax effect.

"(4) **FINANCIAL ACCOUNTING BENEFITS.**—For purposes of paragraph (1)(B), achieving a financial accounting benefit shall not be taken into account as a purpose for entering into a transaction if the origin of such financial accounting benefit is a reduction of Federal income tax.

"(5) **DEFINITIONS AND SPECIAL RULES.**—For purposes of this subsection—

"(A) **ECONOMIC SUBSTANCE DOCTRINE.**—The term 'economic substance doctrine' means the common law doctrine under which tax benefits under subtitle A with respect to a transaction are not allowable if the transaction does not have economic substance or lacks a business purpose.

"(B) **EXCEPTION FOR PERSONAL TRANSACTIONS OF INDIVIDUALS.**—In the case of an individual, paragraph (1) shall apply only to transactions entered into in connection with a trade or business or an activity engaged in for the production of income.

"(C) **DETERMINATION OF APPLICATION OF DOCTRINE NOT AFFECTED.**—The determination of whether the economic substance doctrine is relevant to a transaction shall be made in the same manner as if this subsection had never been enacted.

"(D) **TRANSACTION.**—The term 'transaction' includes a series of transactions.".

(b) PENALTY FOR UNDERPAYMENTS ATTRIBUTABLE TO TRANSACTIONS LACKING ECONOMIC SUBSTANCE.—

(1) IN GENERAL.—Subsection (b) of section 6662 is amended by inserting after paragraph (5) the following new paragraph: "(6) Any disallowance of claimed tax benefits by reason of a transaction lacking economic substance (within the meaning of

section 7701(o)) or failing to meet the requirements of any similar rule of law.".

(2) INCREASED PENALTY FOR NONDISCLOSED TRANSACTIONS.—Section 6662 is amended by adding at the end the following new subsection:

'(i) **INCREASE IN PENALTY IN CASE OF NONDISCLOSED NON-ECONOMIC SUBSTANCE TRANSACTIONS.**—

"(1) **IN GENERAL.**—In the case of any portion of an underpayment which is attributable to one or more nondisclosed noneconomic substance transactions, subsection (a) shall be applied with respect to such portion by substituting '40 percent' for '20 percent'.

"(2) **NONDISCLOSED NONECONOMIC SUBSTANCE TRANSACTIONS.**—For purposes of this subsection, the term 'nondisclosed noneconomic substance transaction' means any portion of a transaction described in subsection (b)(6) with respect to which the relevant facts affecting the tax treatment are not adequately disclosed in the return nor in a statement attached to the return.

"(3) **SPECIAL RULE FOR AMENDED RETURNS.**—In no event shall any amendment or supplement to a return of tax be taken into account for purposes of this

subsection if the amendment or supplement is filed after the earlier of the date the taxpayer is first contacted by the Secretary regarding the examination of the return or such other date as is specified by the Secretary.".

(3) CONFORMING AMENDMENT.—Subparagraph (B) of section 6662A(e)(2) is amended—

(A) by striking "section 6662(h)" and inserting "subsections (h) or (i) of section 6662"; and

(B) by striking "GROSS VALUATION MISSTATEMENT PENALTY" in the heading and inserting "CERTAIN INCREASED UNDERPAYMENT PENALTIES".

(c) REASONABLE CAUSE EXCEPTION NOT APPLICABLE TO NONECONOMIC SUBSTANCE TRANSACTIONS.—

(1) REASONABLE CAUSE EXCEPTION FOR UNDERPAYMENTS.— Subsection (c) of section 6664 is amended—

(A) by redesignating paragraphs (2) and (3) as paragraphs (3) and (4), respectively;

(B) by striking "paragraph (2)" in paragraph (4)(A), as so redesignated, and inserting "paragraph (3)"; and

(C) by inserting after paragraph (1) the following new paragraph:

"**(2) EXCEPTION.**—Paragraph (1) shall not apply to any portion of an underpayment which is attributable to one or more transactions described in section 6662(b)(6)."

(2) REASONABLE CAUSE EXCEPTION FOR REPORTABLE TRANSACTION UNDERSTATEMENTS.—Subsection (d) of section 6664 is amended—

(A) by redesignating paragraphs (2) and (3) as paragraphs (3) and (4), respectively;

(B) by striking "paragraph (2)(C)" in paragraph (4), as so redesignated, and inserting "paragraph (3)(C)"; and (C) by inserting after paragraph (1) the following new paragraph:

"**(2) EXCEPTION**.—Paragraph (1) shall not apply to any portion of a reportable transaction understatement which is attributable to one or more transactions described in section 6662(b)(6).".

(d) APPLICATION OF PENALTY FOR ERRONEOUS CLAIM FOR REFUND OR CREDIT TO NONECONOMIC SUBSTANCE TRANSACTIONS.— Section 6676 is amended by redesignating subsection (c) as subsection (d) and inserting after subsection (b) the following new subsection:

"(c) **NONECONOMIC SUBSTANCE TRANSACTIONS TREATED AS LACKING REASONABLE BASIS.**—For purposes of this section, any excessive amount which is attributable to any transaction described in section 6662(b)(6) shall not be treated as having a reasonable basis.".

(e) EFFECTIVE DATE.—

(1) IN GENERAL.—Except as otherwise provided in this subsection, the amendments made by this section shall apply to transactions entered into after the date of the enactment of this Act.

(2) UNDERPAYMENTS.—The amendments made by subsections (b) and (c)(1) shall apply to underpayments attributable to transactions entered into after the date of the enactment of this Act.

(3) UNDERSTATEMENTS.—The amendments made by subsection (c)(2) shall apply to understatements attributable to transactions entered into after the date of the enactment of this Act.

(4) REFUNDS AND CREDITS.—The amendment made by subsection (d) shall apply to refunds and credits attributable to transactions entered into after the date of the enactment of this Act.

REPLY BRIEF

RECORD
AND
BRIEFS

Supreme Court, U.S.
FILED
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No. 12-562

In the Supreme Court of the United States

UNITED STATES OF AMERICA, PETITIONER

v.

GARY WOODS, AS TAX MATTERS PARTNER OF TESORO DRIVE PARTNERS, ET AL.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

REPLY BRIEF FOR THE UNITED STATES

DONALD B. VERRILLI, JR.
Solicitor General
Counsel of Record
Department of Justice
Washington, D.C. 20530-0001
SupremeCtBriefs@usdoj.gov
(202) 514-2217

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REPLY BRIEF FOR THE UNITED STATES

Respondent does not dispute that there exists a longstanding division of authority among the circuits over whether a taxpayer's underpayment of tax can be "attributable to" a misstatement of basis under 26 U.S.C. 6662 when the transaction that created an inflated basis is disregarded in its entirety as lacking economic substance. See Br. in Opp. 5 (acknowledging "disagreement among the circuits"). Respondent also does not attempt to explain, on the merits, how the minority view adopted by the Fifth and Ninth Circuits can be reconciled with the text and purpose of Section 6662. Rather, he urges the Court to deny review on the grounds that the issue is "obsolete" in light of the 2010 enactment of Section 6662(i) and is otherwise "unimportant." *Id.* at 2, 3.

Respondent is wrong. There are numerous docketed cases in the Fifth and Ninth Circuits in which the government is currently attempting to collect overstatement penalties from taxpayers who, like respondent, engaged in fraudulent tax schemes involving a basis overstatement. As the petition explains (at 31), moreover, the construction of Section 6662 adopted by the Fifth and Ninth Circuits will continue to apply in cases within those circuits where a deduction is entirely disallowed on a ground other than that the underlying transaction lacked economic substance. This Court should accordingly grant review to correct those circuits' erroneous interpretation of the statute.

1. In 2010, Congress added to Section 6662 a new subsection that imposes a 40% penalty on any underpayment of tax that is attributable to a "nondisclosed noneconomic substance transaction" entered into after March 30, 2010. 26 U.S.C. 6662(i) (Supp. V 2011); see Pet. 31. Respondent contends that Section 6662(i) "eliminate[s] any arguable importance the issue in this case might have possessed." Br. in Opp. 3-5.

Thousands of taxpayers, however, engaged in abusive, basis-inflating tax shelters before March 30, 2010. The government is currently pursuing numerous cases against such individuals in which appeals would be heard by the Fifth or Ninth Circuit (or by a circuit that has not yet addressed the question presented). Respondent asserts that "the Government offers no support" for its prediction that the minority rule, if left uncorrected, will deprive it of significant revenue. Br. in Opp. 6. The petition for certiorari, however, identifies a $360 million basis misstatement at issue in a *single case* pending within the Fifth Circuit. See Pet. 30. Eight additional related cases docketed in the Northern District of Texas

involve aggregate basis misstatements of approximately $4 billion,[1] and the government is actively litigating many other cases to which the minority rule currently applies. See, *e.g.*, *NPR Invs., L.L.C.* v. *United States* (5th Cir. No. 10-41219) ($65 million aggregate basis misstatement); *Seashore Broad. Corp.* v. *Commissioner* (Tax Ct. No. 23058-06) (approximately $40 million basis misstatement, appealable to Ninth Circuit); *Goddard* v. *Commissioner* (Tax Ct. Nos. 1145-05, 1504-06, and 20673-09) (approximately $28 million aggregate basis misstatement, appealable to Ninth Circuit). This case alone involves aggregate basis misstatements in excess of $45 million. See Pet. App. 5a-6a.

Those pending cases, involving significant overstatements of basis, illustrate the practical significance of the question presented. Moreover, although a three-year statute of limitations applies to assessments of tax deficiencies resulting from overstatements of basis, see *United States* v. *Home Concrete & Supply, LLC*, 132 S. Ct. 1836, 1839 (2012), taxpayers regularly agree to extend the period of limitations, often multiple times. The government therefore may pursue cases arising out of basis-inflating tax shelters entered into before March 30, 2010, for years to come. Accordingly, although respondent is surely correct that "most taxpayers" do not overstate their bases in property when reporting their taxable income (Br. in Opp. 6), the question presented has significant continuing fiscal importance for the government. The practical significance of the question

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[1] See *Southgate Master Fund, LLC* v. *United States* (Nos. 07-cv-02104, 12-cv-02824, and 12-cv-04480); *Southbrook Master Fund, LLC* v. *United States* (No. 09-cv-00664); *Pinnacle Mgmt. LLC* v. *United States* (Nos. 12-cv-02823 and 12-cv-04484); *Classic Paragon Mgmt. LLC* v. *United States* (Nos. 12-cv-02819 and 12-cv-04482).

presented, together with the lopsided circuit conflict on the issue (see Pet. 21-29), amply justifies further review.

2. Respondent entirely fails to address the fact that Section 6662(i) will have no effect on cases where value- or basis-related deductions are disallowed in full on a ground *other than* a lack of economic substance. See Pet. 31. By providing an authoritative construction of Section 6662's overstatement penalty, this Court's resolution of the question presented will likely resolve that issue as well. The court of appeals' summary ruling in this case (Pet. App. 1a-2a) relied in part on *Heasley* v. *Commissioner*, 902 F.2d 380 (5th Cir. 1990), and *Todd* v. *Commissioner*, 862 F.2d 540 (5th Cir. 1988), which reflect the Fifth Circuit's longstanding view that "[w]henever the I.R.S. totally disallows a deduction or credit, the I.R.S. may not penalize the taxpayer for a valuation overstatement included in that deduction or credit." *Heasley*, 902 F.2d at 383; see Pet. 16-20. If the Court rejects that interpretation of the statute, it will enable the government to collect overstatement penalties in cases where, for example, a claimed charitable deduction that involves a gross misstatement of value is totally disallowed due to the taxpayer's lack of donative intent. See, *e.g.*, *Derby* v. *Commissioner*, 95 T.C.M. (CCH) 1177, 1194 (2008).

3. Respondent also asserts (Br. in Opp. 7) that the government's request for review is "undercut by the fact that the circuit differences identified by the Government have existed for nearly 25 years." But the pre-2000s cases involved relatively simple, low-value schemes. See Pet. 25. The tax deficiencies in *Todd* and *Heasley*, for example, amounted to approximately $125,000 and $23,000, respectively. See *Noonan* v. *Commissioner*, 52 T.C.M. (CCH) 534, 557 (1986) (consolidated test case

involving the Todds), aff'd *sub nom. Hillendahl* v. *Commissioner*, 976 F.2d 737 (9th Cir. 1992); *Heasley*, 902 F.2d at 382. It was only with the proliferation of high-value, basis-inflating shelters like COBRA beginning in the late 1990s—which did not reach appellate courts until the late 2000s—that this issue took on added urgency. See Pet. 7-9.[2]

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[2] The district court in this case decided the question presented in a partnership-level proceeding, exercising jurisdiction under 26 U.S.C. 6226(a)(2). See Pet. App. 15a-16a. The court in such a proceeding "shall have jurisdiction to determine all partnership items of the partnership * * * and the applicability of any penalty, addition to tax, or additional amount which relates to an adjustment to a partnership item." 26 U.S.C. 6226(f). Respondent did not contest the jurisdiction of the courts below to determine the threshold applicability of the basis-overstatement penalty, and the courts' assertion of jurisdiction was authorized by Section 6226(a) and (f).

Two recent appellate decisions have called into question, without definitively resolving, whether the court in a partnership-level proceeding may determine the threshold applicability of the overstatement penalty for a partnership's participation in sham transactions. See *Petaluma FX Partners, LLC* v. *Commissioner*, 591 F.3d 649, 655-656 (D.C. Cir. 2010); *Jade Trading, LLC* v. *United States*, 598 F.3d 1372, 1378-1380 (Fed. Cir. 2010). Both the Tax Court and the Court of Federal Claims have since concluded, however, that those decisions, properly understood, do not preclude partnership-level review of penalty issues similar to the one presented here. See *Tigers Eye Trading, LLC* v. *Commissioner*, 138 T.C. 67, 130-134 (2012); *Arbitrage Trading, LLC* v. *United States*, No. 06-202, 2013 WL 365601, at *13 (Fed. Cl. Jan. 30, 2013). *Petaluma* has twice been remanded to the Tax Court for further proceedings, and the government's appeal from the most recent Tax Court decision in the case is currently pending before the D.C. Circuit (No. 12-1364).

If this Court concludes that the question presented in the petition otherwise warrants review, the jurisdictional issue described above provides no reason to view this case as an unsuitable vehicle for resolving it. A jurisdictional issue could arise in any case raising the

* * * * *

For the foregoing reasons and those stated in the petition for a writ of certiorari, the petition for a writ of certiorari should be granted.

Respectfully submitted.

DONALD B. VERRILLI, JR.
Solicitor General
Counsel of Record

FEBRUARY 2013

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question presented—whether a partnership-level or partner-level proceeding—because matters that may be decided in a partnership-level proceeding may not be decided in a partner-level proceeding, and vice versa. See 26 U.S.C. 6221, 6230(a)(2)(A)(i), (c)(4), and (c)(5)(D). Moreover, because courts in practice have determined the applicability of penalties at the partnership level, appropriately precluding consideration of that threshold issue at the partner level, the vehicles available to this Court for resolving the question presented can be expected to resemble this case in that they will arise from partnership-level proceedings.

JOINT APPENDIX

ECORD
AND
BRIEFS

FILED
MAY
OFFICE OF THE CLERK

No. 12-562

In the Supreme Court of the United States

UNITED STATES OF AMERICA, PETITIONER

v.

GARY WOODS, AS TAX MATTERS PARTNER OF TESORO DRIVE PARTNERS, ET AL.

ON WRIT OF CERTIORARI
TO THE UNITED STATES COURT OF APPEALS
FOR THE FIFTH CIRCUIT

JOINT APPENDIX

DONALD B. VERRILLI, JR.
Solicitor General
Department of Justice
Washington, D.C. 20530-0001
SupremeCtBriefs@usdoj.gov
(202) 514-2217

Counsel of Record
for Petitioner

GREGORY G. GARRE
Latham & Watkins, LLP
555 11th Street, N.W.,
Suite 1000
Washington, D.C. 20004
gregory.garre@lw.com
(202) 637-2207

Counsel of Record
for Respondents

PETITION FOR A WRIT OF CERTIORARI FILED: NOV. 6, 2012
CERTIORARI GRANTED: MAR. 25, 2012

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Exhibit 252—IRS Form 1120S 190

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UNITED STATES COURT OF APPEALS
FOR THE FIFTH CIRCUIT

Docket No. 11-50487

GARY WOODS, AS TAX MATTERS PARTNER OF TESORO DRIVE PARTNERS, A TEXAS GENERAL PARTNERSHIP, PLAINTIFF-APPELLEE

v.

UNITED STATES OF AMERICA, DEFENDANT-APPELLANT

DOCKET ENTRIES

DATE	PROCEEDINGS
6/2/11	US CIVIL CASE docketed. NOA filed by Appellant United States [11-50487] (SDH)
6/2/11	CASE CAPTION updated. Additional appeal filed. [6825483-2] NOA filed by Appellant United States. [6825483-1] [11-50487] (SDH)
6/8/11	APPEARANCE FORM FILED by Attorney(s) Arthur Thomas Catterall for party(s) Appellant United States, in case 11-50487 [11-50487] (MVM)

DATE	PROCEEDINGS
6/10/11	INITIAL CASE CHECK by Attorney Advisor complete, Action: Case OK to Process after monitoring for Document #83—Motion to Amend Judgment. [6831997-2] Initial AA Check Due satisfied.. Awaiting DC Action due on 06/28/2011 [11-50487] (MVM)
6/13/11	CASE CAPTION updated. Cross appeal filed. [6833424-2] Parties updated: Appellant Cross-Appellee United States, Appellee Cross-Appellant Gary Woods in 11-50487. NOA filed by Appellee Mr. Gary Woods. [6833424-1] [11-50487] (NFD)
6/15/11	APPEARANCE FORM FILED by Attorney(s) Joel N Crouch for party(s) Appellee Cross-Appellant Gary Woods, in case 11-50487 [11-50487] (MVM)
6/22/11	APPEARANCE FORM FILED by Attorney Anthony P Daddino for Appellee Cross-Appellant Gary Woods in 11-50487 [11-50487] (MVM)
6/22/11	INITIAL CASE CHECK by Attorney Advisor complete, Action: Case OK to Process after monitoring for Docket #83, Motion to Amend Judgment. [6841165-2] Initial AA Check Due satisfied. [11-50487] (MVM)

DATE	PROCEEDINGS
8/9/11	DISTRICT COURT ORDER of 08/05/2011 denying Doc. 183—motion to alter or amend judgement. Awaiting District Court Action deadline satisfied [11-50487] (MFY)
9/9/11	FEE PAID by Appellee Cross-Appellant Mr. Gary Woods. Fee deadline satisfied [11-50487] (MVM)
9/9/11	Request issued to district court to CERTIFY THE RECORD ON APPEAL. Notice of Certified ROA Due on 09/26/2011. [11-50487] (MVM)
9/27/11	NOTICE RECEIVED FROM DISTRICT COURT. ROA Certified by DCt, FILED Certified ROA due deadline satisfied. [11-50487] (MVM)
10/3/11	BRIEFING NOTICE ISSUED A/Pet's Brief Due on 11/14/2011 for Appellant Cross-Appellee United States. [11-50487] (MVM)
10/18/11	APPEARANCE FORM FILED by Attorney(s) Stephanie Dawn Mongiello for party(s) Appellee Cross-Appellant Gary Woods, in case 11-50487 [11-50487] (MVM)

DATE	PROCEEDINGS
11/3/11	PHONE EXTENSION CONFIRMED for Appellant Cross-Appellee United States. Extension granted to and including 11/21/2011. A/Pet's Brief deadline updated to 11/21/2011 for Appellant Cross-Appellee United States [11-50487] (MVM)
11/21/11	APPELLANT'S BRIEF FILED by United States Date of service: 11/21/2011 via email—Attorney for Appellant Cross-Appellee: Catterall; Attorney for Appellees Cross-Appellants: Crouch, Daddino, Mongiello; US mail—Attorney for Appellant Cross-Appellee: Donohue [11-50487] REVIEWED AND/OR EDITED. # of Copies Provided: 0 A/Pet's Brief deadline satisfied. XA/Pet's Brief due on 12/27/2011 for Appellee Cross-Appellant Gary Woods.. Paper Copies of Brief due on 11/28/2011 for Appellant Cross-Appellee United States. [11-50487] (Arthur Thomas Catterall)
11/21/11	RECORD EXCERPTS FILED by Appellant Cross-Appellee United States. Date of service: 11/21/2011 via email—Attorney for Appellant Cross-Appellee: Catterall; Attorney for Appellees Cross-Appellants: Crouch, Daddino, Mongiello; US mail—Attorney for Appellant Cross-Appellee: Donohue [11-50487] REVIEWED AND/OR EDITED.. # of Copies Provided: 0 Paper Copies of Record Excerpts due on 11/28/2011 for Appellant Cross-Appellee

DATE	PROCEEDINGS
	United States. [11-50487] (Arthur Thomas Catterall)
11/21/11	APPEARANCE FORM FILED by Attorney(s) Gilbert Steven Rothenberg for party(s) Appellant Cross-Appellee United States, in case 11-50487 [11-50487] (MVM)
11/21/11	APPEARANCE FORM FILED by Attorney(s) Tamara W. Ashford for party(s) Appellant Cross-Appellee United States, in case 11-50487 [11-50487] (MVM)
11/21/11	APPEARANCE FORM FILED by Attorney(s) Richard Bradshaw Farber for party(s) Appellant Cross-Appellee United States, in case 11-50487 [11-50487] (MVM)
11/25/11	Paper copies of appellant brief filed by Appellant Cross-Appellee United States in 11-50487 received. Paper copies match electronic version of document? Yes. # of Copies Provided: 7. Paper Copies of Brief due deadline satisfied. [11-50487] (RJd)
11/25/11	Paper copies of record excerpts filed by Appellant Cross-Appellee United States in 11-50487 received. Paper copies match electronic version of document? Yes. # of Copies Provided: 4. Paper Copies of Record Excerpts due deadline satisfied. [11-50487] (RJd)

DATE	PROCEEDINGS
12/13/11	UNOPPOSED MOTION filed by Appellee Cross-Appellant Mr. Gary Woods to Voluntarily Dismiss Cross-Appeal. Date of service: 12/13/2011 via email—Attorney for Appellants Cross-Appellees: Ashford, Catterall, Farber, Rothenberg; Attorney for Appellees Cross-Appellants: Crouch, Daddino, Mongiello; US mail—Attorney for Appellant Cross-Appellee: Donohue [11-50487] (Joel N. Crouch)
12/14/11	CLERK ORDER FILED granting motion to dismiss appeal pursuant to Fed. R. App. P. 42 filed by Appellee Cross-Appellant Mr. Gary Woods [6970881-2] Statistical Number: 1150513 [11-50487] (MVM)
12/14/11	CASE CAPTION updated. Party information modified for United States and Gary Woods in 11-50487. Update: The parties are now appellant/appelles as the cross appeal has been dismissed.. [11-50487] (MVM)
12/27/11	APPELLEE'S BRIEF FILED by Appellee Mr. Gary Woods Date of service: 12/27/2011 via email—Attorney for Appellants: Ashford, Catterall, Farber, Rothenberg; Attorney for Appellees: Crouch, Daddino, Mongiello; US mail—Attorney for Appellant: Donohue [11-50487] REVIEWED AND/OR EDITED. APPELLEE'S BRIEF FILED # of Copies Provided: 0 E/Res's Brief deadline satisfied.

DATE	PROCEEDINGS
	Reply Brief due on 01/13/2012 for Appellant United States. Paper Copies of Brief due on 01/04/2012 for Appellee Gary Woods. [11-50487] (Joel N. Crouch)
1/4/12	Paper copies of appellee brief filed by Appellee Mr. Gary Woods in 11-50487 received. Paper copies match electronic version of document? Yes # of Copies Provided: 7. Paper Copies of Brief due deadline satisfied. [11-50487] (MVM)
1/6/12	OPPOSED MOTION filed by Appellant United States to extend time to file reply brief until 01/20/2012 [6988053-2]. Date of service: 01/06/2012 via email—Attorney for Appellants: Ashford, Catterall, Farber, Rothenberg; Attorney for Appellees: Crouch, Daddino, Mongiello; US mail—Attorney for Appellant: Donohue [11-50487] (Arthur Thomas Catterall)
1/6/12	RESPONSE/OPPOSITION filed by Mr. Gary Woods [6988389-1] to the motion to extend time to file reply brief filed by Appellant United States in 11-50487 [6988053-2] Date of Service: 01/06/2012 via email—Attorney for Appellants: Ashford, Catterall, Farber, Rothenberg; Attorney for Appellees: Crouch, Daddino, Mongiello; US mail—Attorney for Appellant: Donohue. [11-50487] REVIEWED AND/OR EDITED. RESPONSE/

DATE	PROCEEDINGS
	OPPOSITION [6988389-1] to the motion to extend time to file reply brief filed by Appellant United States in 11-50487 [6988053-2] [11-50487] (Joel N. Crouch)
1/9/12	RECORD ON APPEAL FILED. Electronic Pleadings, 8; ElectronicTranscript, 8; Exhibits, 1 Box (Trial Exhibits); Exhibits, 1 Box (Trial Exhibits); Exhibits, 1 Box (Trial Exhibits); [11-50487] (MVM)
1/9/12	CLERK ORDER granting motion to extend time to file reply brief filed by Appellant United States [6988053-2] Reply Brief deadline updated to 01/20/2012 for Appellant United States. [11-50487] (MVM)
1/20/11	APPELLANT'S REPLY BRIEF FILED by United States Date of service: 01/20/2012 via email—Attorney for Appellants: Ashford, Catterall, Farber, Rothenberg; Attorney for Appellees: Crouch, Daddino, Mongiello; US mail—Attorney for Appellant: Donohue [11-50487] REVIEWED AND/OR EDITED. # of Copies Provided: 0 Reply Brief deadline satisfied. Paper Copies of Brief due on 01/30/2012 for Appellant United States. [11-50487] (Arthur Thomas Catterall)
1/23/12	Paper copies of appellant reply brief filed by Appellant United States in 11-50487 received. Paper copies match electronic version of docu-

DATE	PROCEEDINGS
	ment? Yes # of Copies Provided: 7. Paper Copies of Brief due deadline satisfied. [11-50487] (SMH)
4/10/12	CASE TENTATIVELY calendared for oral argument for the week of 06/04/2012. [11-50487] (GAM)
4/27/12	CASE CALENDARED for oral argument on Wednesday, 06/06/2012 in New Orleans in the West Courtroom—AM session. In accordance with our policy, lead counsel only will receive via email at a later date a copy of the court's docket and an acknowledgment form. All other counsel of record should monitor the court's website for the posting of the oral argument calendars.. [11-50487] (PFT)
5/3/12	SUPPLEMENTAL AUTHORITIES (FRAP 28j) FILED by Appellee Mr. Gary Woods Date of Service: 05/03/2012 via email—Attorney for Appellants: Ashford, Catterall, Farber, Rothenberg; Attorney for Appellees: Crouch, Daddino, Mongiello; US mail—Attorney for Appellant: Donohue [11-50487] (Joel N. Crouch)
5/3/12	RESPONSE/OPPOSITION filed by United States [7079512-1] to the 28j letter filed by Appellee Mr. Gary Woods in 11-50487 [7078833-2] Date of Service: 05/03/2012 via email—Attorney for Appellants: Ashford, Catterall, Farber, Rothenberg; Attorney for

DATE	PROCEEDINGS
	Appellees: Crouch, Daddino, Mongiello; US mail—Attorney for Appellant: Donohue. [11-50487] (Arthur Thomas Catterall)
5/24/12	UNOPPOSED MOTION filed by Appellee Mr. Gary Woods to stay further proceedings and oral argument in this court pending a decision in case No. 10-41132, Bemont Investors, LLC v. United States. Date of service: 05/24/2012 via email—Attorney for Appellants: Ashford, Catterall, Farber, Rothenberg; Attorney for Appellees: Crouch, Daddino, Mongiello; US mail—Attorney for Appellant: Donohue [11-50487] (Joel N. Crouch)
5/29/12	COURT ORDER granting unopposed motion to stay further proceedings and oral argument in this court pending a decision in case No. 10-41132, Bemont Investors, LLC v. United States filed by Appellee Mr. Gary Woods [7095086-2] This case will be decided on a no-oral-argument calendar. [11-50487] (PFT)
5/29/12	CHANGE CALENDAR information. The panel to whom the above referenced case is assigned has determined under FRAP 34(a) that oral argument will not be required in this case. Therefore, counsel need not appear for argument on Wednesday, June 6, 2012. [11-50487] (PFT)

DATE	PROCEEDINGS
6/6/12	UNPUBLISHED OPINION FILED. [11-50487 Affirmed] Judge: EHJ, Judge: JLW, Judge: JEG Mandate pull date is 07/30/2012 [11-50487] (RMF)
6/6/12	JUDGMENT ENTERED AND FILED. [11-50487] (RMF)
6/20/12	BILL OF COSTS filed by Appellee Mr. Gary Woods. [11-50487] (Joel N. Crouch)
6/29/12	OBJECTION filed by Appellant United States to the Bill of Costs filed by Appellee Mr. Gary Woods in 11-50487 [7115351-2] Date of Service: 06/29/2012 via email—Attorney for Appellants: Ashford, Catterall, Farber, Rothenberg; Attorney for Appellees: Crouch, Daddino, Mongiello; US mail—Attorney for Appellant: Donohue [11-50487] (Arthur Thomas Catterall)
7/2/12	RESPONSE DUE to objection Bill of Costs filed by Appellant United States in 11-50487 [7123767-2] Response/Opposition due on 07/09/2012 [11-50487] (DMS)
7/17/12	PETITION filed by Appellant United States for rehearing en banc [7136621-2]. Date of Service: 07/17/2012 via email—Attorney for Appellants: Ashford, Catterall, Farber, Rothenberg; Attorney for Appellees: Crouch, Daddino, Mongiello; US mail—Attorney for Appellant: Donohue [11-50487] (Arthur Thomas Catterall)

DATE	PROCEEDINGS
7/17/12	PAPER COPIES REQUESTED for the petition for rehearing en banc filed by Appellant United States in 11-50487 [7136621-2]. Paper Copies of Rehearing due on 07/23/2012 for Appellant United States. [11-50487] (MVM)
7/20/12	Paper copies of petition for rehearing en banc filed by Appellant United States in 11-50487 received. Paper copies match electronic version of document? Yes # of Copies Provided: 20. Paper Copies of Rehearing due deadline satisfied. [11-50487] (MVM)
7/26/12	COURT ORDER sustaining appellant's objection Bill of Costs filed by Appellant United States [7123767-2] Judge(s): JEG. [11-50487] (SAT)
8/8/12	COURT ORDER denying petition for rehearing en banc filed by Appellant United States [7136621-2] Without Poll. Mandate pull date is 08/15/2012 [11-50487] (MVM)
8/16/12	MANDATE ISSUED. Mandate pull date satisfied. The Bill of Costs is issued with the mandate. [11-50487] (MVM)
8/23/12	AMENDED BILL OF COSTS filed by Appellee Mr. Gary Woods. [11-50487] (MVM)

DATE	PROCEEDINGS
8/23/12	LETTER OF ADVISEMENT. Reason: pursuant to the Court Order of 7/26/12 an amended bill of cost is issued to all parties and the District Court Clerk. [11-50487] (MVM)
11/7/12	SUPREME COURT NOTICE that petition for writ of certiorari [7223936-2] was filed by Appellee Mr. Gary Woods on 11/06/2012. Supreme Court Number: 12-562. [11-50487] (LGL)
3/25/13	SUPREME COURT ORDER received granting petition for writ of certiorari filed by Appellee Mr. Gary Woods in 11-50487 on 03/25/2013. [7324305-1] [11-50487] (CAV)

UNITED STATES DISTRICT COURT
FOR THE WESTERN DISTRICT OF TEXAS
(San Antonio)

Docket No. 5:05-cv-00216-HLH
GARY WOODS, AS TAX MATTERS PARTNER OF TESORO DRIVE PARTNERS, A TEXAS GENERAL PARTNERSHIP, PLAINTIFF

v.

UNITED STATES OF AMERICA, DEFENDANT

DOCKET ENTRIES

DATE FILED	DOCKET NUMBER	DOCKET TEXT
3/18/05		Case assigned to Judge Xavier Rodriguez (ep) (Entered: 03/21/2005)
3/18/05		If ordered by the court, all referrals will be assigned to Magistrate Judge Nowak (ep) (Entered: 03/21/2005)
3/18/05	1	Complaint filed. Filing Fee: $250.00 Receipt # 194353 (ep) Modified on 03/22/2005 Modified

DATE FILED	DOCKET NUMBER	DOCKET TEXT
		on 6/15/2006 (mj,). (Entered: 03/21/2005)
3/18/05		Summons issued for United States, Johnny Sutton (J.S. Attorney), Patrick Kelly (IRS), Bert Snider (IRS), Kevin Harris (IRS), Farris Fink (IRS), John Ashcroft (US Attny General) and Tim Faulk (IRS) (ep) (Entered: 03/21/2005)
4/15/05		Summons issued for Kevin Harris, Territory Manger, Small Business/ Self Employed Business Division (ep) (Entered: 04/15/2005)
5/5/05	2	Motion by United States to enlarge time to answer or otherwise respond to complaint (sj) (Entered: 05/06/2005)
5/10/05	3	Order granting motion to enlarge time to answer or otherwise respond to complaint [2-1] to until 7/26/05. signed by Judge Xavier Rodriguez (rg) (Entered: 05/11/2005)
7/25/05	4	Answer by United States to Petition for readjustment on partnership items under code section 6226 (tm) (Entered: 07/26/2005)

DATE FILED	DOCKET NUMBER	DOCKET TEXT
8/8/05	5	Notice of right to consent to disposition of a civil case by a U.S. Magistrate. Parties are to submit appropriate election form within 30 days of this order. Proposed scheduling order due 9/26/05. (rg1) (Entered: 08/09/2005)
9/2/05	6	Non-consent to proceed before a U.S. Magistrate by United States (ct) (Entered: 09/06/2005)
9/6/05	7	Non-consent to proceed before a U.S. Magistrate by Gary Woods (rg1) (Entered: 09/07/2005)
9/9/05		Received notice from the USA of motions to transfer to the Judicial Panel on Multidistrict Litigation (tm) (Entered: 09/12/2005)
9/12/05	8	Unopposed motion by Gary Woods with memorandum in support to consolidate cases (ga) Modified on 09/13/2005 (Entered: 09/13/2005)
9/14/05	9	Order granting motion to consolidate cases [8-1] signed by Judge Xavier Rodriguez (tm) (Entered: 09/15/2005)

DATE FILED	DOCKET NUMBER	DOCKET TEXT
9/30/05	10	Notice of filing by Gary Woods regarding filing of pleading in the Judicial Panel on Multidistrict Litigation of the United States (tm) (Entered: 10/03/2005)
10/5/05	11	Scheduling order setting; Alternate Dispute Resolution Report due by 11/14/05; Joining of parties, amending of pleadings on 12/30/05; Discovery cutoff 9/29/06; Deadline for filing of all dispositive motions 9/29/06; Pretrial conference of attorneys by 9:30 1/17/07; Bench trial set for 9:30; Pretrial order to be submitted on or before 1/5/07 signed by Judge Xavier Rodriguez (tm) (Entered: 10/06/2005)
10/18/05	12	Reply memorandum in support of its motion to transfer filed by United States (tm) (Entered: 10/19/2005)
10/18/05	13	Reasons why oral arguement should be heard filed by United States (tm) (Entered: 10/19/2005)

DATE FILED	DOCKET NUMBER	DOCKET TEXT
10/18/05	14	Appendix of exhibits in support of its motion to transfer [12-1] by United States (tm) (Entered: 10/19/2005)
11/14/05	15	Joint Alternate Dispute Resolution Report filed by Gary Woods, United States, Party(s) do not agree to Alternate Dispute Resolution (rg1) (Entered: 11/16/2005)
1/13/06	16	Certified Order of TRANSFER to the Judicial Panel of Multidistrict Litigation no. 1727 in Southern District of Indiana (tm) (Entered: 01/17/2006)
1/13/06		Case closed (tm) (Entered: 1/17/2006)
1/17/06		Sent original documents and a certified copy of the docket sheet to the MDL Panel by certified mail (tm) (Entered: 01/17/2006)
4/17/09	17	COPY OF ORDER on MDL Docket #1727 REMANDING CASE. (ep,) (Entered: 04/20/2009)
6/25/09	18	Southern District of Indiana (Indianapolis) Docket Sheet for case:

DATE FILED	DOCKET NUMBER	DOCKET TEXT
		#1:06-cv-8000-WTL-DML (ep,) (Entered: 06/26/2009)
6/25/09	19	Southern District of Indiana (Indianapolis) Docket Sheet for MDL case: # 1:05-ml-09727-WTL-TAB
6/25/09	20	JOINT STIPULATION of Remand by Gary Woods, United States. (ep,) (Entered: 06/26/2009)
6/25/09	21	Copy of CONDITIONAL REMAND ORDER (ep,) (Entered: 06/26/2009)
8/5/09	22	NOTICE *of Relevant Judicial Decision* by Gary Woods (Attachments: # 1 Exhibit A)(Crouch, Joel) (Entered: 08/05/2009)
11/20/09	23	TRANSFER ORDER REASSIGNING CASE. Case reassigned to Judge Harry Lee Hudspeth for all proceedings. Judge Xavier Rodriguez no longer assigned to case. Signed by Judge Xavier Rodriguez. (ep,) (Entered: 11/20/2009)

DATE FILED	DOCKET NUMBER	DOCKET TEXT
12/2/09	24	NOTICE *of Withdrawal of Counsel Welty* by Gary Woods (Welty, M.) (Entered: 12/02/2009)
12/8/09	25	ORDER ALLOWING WITHDRAWAL OF COUNSEL re 24 Notice (Other) filed by Gary Woods. Signed by Judge Harry Lee Hudspeth. (ep,) (Entered: 12/08/2009)
12/15/09	26	SCHEDULING ORDER (Bench Trial set for 8/2/2010 09:30 AM before Judge Harry Lee Hudspeth., Dispositive Motions due by 6/1/2010., Pretrial Submissions due no later than 7/19/2010.) Signed by Judge Harry Lee Hudspeth. (rg) (Entered: 12/15/2009)
12/18/09	27	NOTICE of Attorney Appearance by Stephanie D. Mongiello on behalf of Gary Woods (Mongiello, Stephanie) (Entered: 12/18/2009)
12/18/09	28	Unopposed MOTION *to Continue Trial Until September 7, 2010* by Gary Woods. (Attachments: # 1 Proposed Order) (Crouch, Joel) (Entered: 12/18/2009)

DATE FILED	DOCKET NUMBER	DOCKET TEXT
12/22/09	29	ORDER REGARDING PLAINTIFF'S MOTION FOR A CONTINUANCE. GRANTING 28 Motion to Continue Signed by Judge Harry Lee Hudspeth. (ep,) (Entered: 12/23/2009)
12/22/09		Reset Hearings: Bench Trial set for 9/7/2010 09:30 AM before Judge Harry Lee Hudspeth. (ep,) (Entered: 12/23/2009)
6/4/10	30	ORDER MODIFYING TRIAL SETTING (Bench Trial reset for 9/13/2010 09:30 AM before Judge Harry Lee Hudspeth.). Signed by Judge Harry Lee Hudspeth. (tm) (Entered: 06/04/2010)
6/7/10	31	MOTION to Appear Pro Hac Vice by Dennis M. Donohue by on behalf of United States. (Donohue, Dennis) (Entered: 06/07/2010)
6/8/10	32	ORDER REGARDING MOTIONS TO EXCLUDE WITNESSES. Signed by Judge Harry Lee Hudspeth. (tm) (Entered: 06/09/2010)
6/9/10	33	ORDER GRANTING 31 Motion to Appear Pro Hac Vice. Pursuant

DATE FILED	DOCKET NUMBER	DOCKET TEXT
		to our Administrative Policies and Procedures for Electronic Filing, the attorney hereby granted to practice pro hac vice in this case must register for electronic filing with our court within 10 days of this order. Signed by Judge Harry Lee Hudspeth. (tm) (Entered: 06/09/2010)
6/16/10	34	Motion to Waive Court Fee for Government Attorney by Dennis M. Donohue. (Attachments: # 1 Proposed Order)(Donohue, Dennis) Modified on 6/16/2010 (tm). (Entered: 06/16/2010)
6/16/10		***Notice of Correction: re 34 MOTION to Waive Court Fee for Government Attorney. Docket text was edited by the clerk.*** (tm) (Entered: 06/16/2010)
6/17/10	35	ORDER GRANTING 34 Motion to Waive Admission Fee. Signed by Judge Harry Lee Hudspeth. (tm) (Entered: 06/18/2010)

DATE FILED	DOCKET NUMBER	DOCKET TEXT
6/28/10	36	MOTION to Appear Pro Hac Vice by John A. Lindquist by on behalf of United States. (tm) (Entered: 06/29/2010)
7/1/10	37	ORDER GRANTING 36 Motion to Appear Pro Hac Vice. Pursuant to our Administrative Policies and Procedures for Electronic Filing, the attorney hereby granted to practice pro hac vice in this case must register for electronic filing with our court within 10 days of this order. Signed by Judge Harry Lee Hudspeth. (tm) (Entered: 07/01/ 2010)
8/30/10	38	Witness List by United States. (Blacker, Jonathan) (Entered: 08/30/ 2010)
8/30/10	39	Exhibit List by United States.. (Attachments: # 1 Appendix A) (Blacker, Jonathan) (Entered: 08/30/ 2010)
8/30/10	40	Proposed Findings of Fact by United States, Gary Woods *Agreed Findings of Fact*. (Blacker, Jonathan) (Entered: 08/30/2010)

DATE FILED	DOCKET NUMBER	DOCKET TEXT
8/30/10	41	NOTICE *United States' Estimated Length of Trial* by United States (Bracker, Jonathan) (Entered: 08/30/2010)
8/30/10	42	Witness List by United States *For Witnesses Presented by Designation.* (Attachments: # 1 Appendix A—list of Merk Designations, # 2 Appendix B—list of Keating Designatons, # 3 Appendix C—list of Coplan Designations, # 4 Appendix D—list of Shapiro Designatoins, # 5 Appendix E—list of Nissebaum Designations, # 6 Appendix F—list of Parse Designatoins) (Lindquist, John) (Entered: 08/30/2010)
8/30/10	43	Proposed Findings of Fact by United States *and Proposed Conclusions of Law.* (Lindquist, John) (Entered: 08/30/2010)
8/30/10	44	NOTICE *of Plaintiffs' Estimated Length of Trial* by Gary Woods (Crouch, Joel) (Entered: 08/30/2010)
8/30/10	45	Exhibit List by Gary Woods..

DATE FILED	DOCKET NUMBER	DOCKET TEXT
		(Attachments: # 1 Appendix A) (Crouch, Joel) (Entered: 08/30/2010)
8/30/10	46	Witness List by Gary Woods. (Crouch, Joel) (Entered: 08/30/2010)
8/30/10	47	Witness List by Gary Woods *Plaintiffs' Deposition Designations.* (Crouch, Joel) (Entered: 08/30/2010)
8/30/10	48	Proposed Findings of Fact by Gary Woods *and Conclusions of Law.* (Crouch, Joel) (Entered: 08/30/2010)
9/6/10	49	Exhibit List *Plaintiffs' Objections to Defendant's Exhibits* by Gary Woods.. (Attachments: # 1 Exhibit A) (Crouch, Joel) (Entered: 09/06/2010)
9/6/10	50	Witness List by Gary Woods *Plaintiffs' Objections and Cross-Designations to United States' Designations.* (Attachments: # 1 Exhibit A) (Crouch, Joel) (Entered: 09/06/2010)
9/6/10	51	Exhibit List *Objections* by United

DATE FILED	DOCKET NUMBER	DOCKET TEXT
		States.. (Attachments: # 1 Appendix List of Defendant's Objections to Plaintiffs' Listed Exhibits) (Lindquist, John) (Entered: 09/06/2010)
9/6/10	52	Witness List by United States *of Counter-Designations and Objections to Plaintiffs Designations.* (Attachments: # 1 Appendix A. Brooks counter-designations, # 2 Appendix B.Keating counter-designations, # 3 Appendix Michaels counter-designations) (Lindquist, John) (Entered: 09/06/2010)
9/13/10	53	Amended Exhibit List by Gary Woods. (tm) (Entered: 09/13/2010)

DATE FILED	DOCKET NUMBER	DOCKET TEXT
9/13/10	54	Minute Entry for proceedings held before Judge Harry Lee Hudspeth: Bench Trial begun on 9/13/2010 (Minute entry documents are not available electronically.), Bench Trial held on 9/13/2010 (Minute entry documents are not available electronically.). (Court Reporter Arlinda Rodriguez & Barbara Durrand-Hollis.) (tm) (Entered: 09/14/2010)
9/14/10	55	Memorandum of Authority on Relevancy by United States (tm) (Entered: 09/14/2010)
9/14/10	56	Minute Entry for proceedings held before Judge Harry Lee Hudspeth: Bench Trial held on 9/14/2010 (Minute entry documents are not available electronically.). (Court Reporter Arlinda Rodriguez & Barbara Durrand-Hollis.) (tm) (Entered: 09/15/2010)
9/15/10	57	Transcript filed of Proceedings held on September 13, 2010, Proceedings Transcribed: Non-Jury

DATE FILED	DOCKET NUMBER	DOCKET TEXT
		Trial (Volume I). Court Reporter/ Transcriber: Arlinda Rodriguez, Telephone number: (210) 340-6464. Parties are notified of their duty to review the transcript to ensure compliance with the FRCP 5.2(a)/FRCrP 49.1(a). A copy may be purchased from the court reporter or viewed at the clerk's office public terminal. If redaction is necessary, a Notice of Redaction Request must be filed within 21 days. If no such Notice is filed, the transcript will be made available via PACER without redaction after 90 calendar days. The clerk will mail a copy of this notice to parties not electronically noticed. Redaction Request due 10/6/2010. Redacted Transcript Deadline set for 10/18/2010. Release of Transcript Restriction set for 12/14/2010. (ep,) (Entered: 09/15/2010)
9/15/10	58	Transcript filed of Proceedings held on September 14, 2010, Proceedings Transcribed: Non-Jury Trial (Volume II). Court Re-

DATE FILED	DOCKET NUMBER	DOCKET TEXT
		porter/Transcriber: Arlinda Rodriguez, Telephone number: (210) 340-6464. Parties are notified of their duty to review the transcript to ensure compliance with the FRCP 5.2(a)/FRCrP 49.1(a). A copy may be purchased from the court reporter or viewed at the clerk's office public terminal. If redaction is necessary, a Notice of Redaction Request must be filed within 21 days. If no such Notice is filed, the transcript will be made available via PACER without redaction after 90 calendar days. The clerk will mail a copy of this notice to parties not electronically noticed. Redaction Request due 10/6/2010. Redacted Transcript Deadline set for 10/18/2010. Release of Transcript Restriction set for 12/14/2010. (ep,) (Entered: 09/15/ 2010)
9/15/10	59	Minute Entry for proceedings held before Judge Harry Lee Hudspeth: Bench Trial held on 9/15/2010 (Minute entry documents are not available electroni-

DATE FILED	DOCKET NUMBER	DOCKET TEXT
		cally.). (Court Reporter Arlinda Rodriguez & Barbara Durrand-Hollis.) (tm) (Entered: 09/15/2010)
9/16/10	60	MOTION to Quash Calling of Songy as a Rebuttal Witness by United States. (tm) (Entered: 09/16/ 2010)
9/16/10	63	Minute Entry for proceedings held before Judge Harry Lee Hudspeth: Bench Trial Held and Completed on 9/16/2010 (Minute entry documents are not available electronically.). (Court Reporter Arlinda Rodriguez & Barbara Durrand-Hollis.) (tm) (Entered: 09/17/2010)
9/16/10	64	Non-Jury Trial Exhibit List for United States and Gary Woods. (tm) (Entered: 09/17/2010)
9/17/10	61	Transcript filed of Proceedings held on 9/15/10, Proceedings Transcribed: Non-Jury Trial— Vol III Morning Session. Court Reporter/Transcriber: Arlinda Rodriguez, Telephone number: (210) 340-6464. Parties are notified of their duty to review the transcript

DATE FILED	DOCKET NUMBER	DOCKET TEXT
		to ensure compliance with the FRCP 5.2(a)/FRCrP 49.1(a). A copy may be purchased from the court reporter or viewed at the clerk's office public terminal. If redaction is necessary, a Notice of Redaction Request must be filed within 21 days. If no such Notice is filed, the transcript will be made available via PACER without redaction after 90 calendar days. The clerk will mail a copy of this notice to parties not electronically noticed Redaction Request due 10/8/2010. Redacted Transcript Deadline set for 10/18/2010. Release of Transcript Restriction set for 12/16/2010. (aej,) (Entered: 09/17/2010)
9/17/10	62	Transcript filed of Proceedings held on 9/15/10, Proceedings Transcribed: Non-Jury Trial—Vol III Afternoon Session. Court Reporter/Transcriber: Barbara Durand- Hollis, Telephone number: (210) 340-6464. Parties are notified of their duty to review the transcript to ensure compliance

DATE FILED	DOCKET NUMBER	DOCKET TEXT
		with the FRCP 5.2(a)/FRCrP 49.1(a). A copy may be purchased from the court reporter or viewed at the clerk's office public terminal. If redaction is necessary, a Notice of Redaction Request must be filed within 21 days. If no such Notice is filed, the transcript will be made available via PACER without redaction after 90 calendar days. The clerk will mail a copy of this notice to parties not electronically noticed Redaction Request due 10/8/2010. Redacted Transcript Deadline set for 10/18 /2010. Release of Transcript Restriction set for 12/16/2010. (aej,) (Entered: 09/17/2010)
9/21/10	65	Transcript filed of Proceedings held on 9/13/10, Proceedings Transcribed: Trial—Vol 1 Afternoon Session. Court Reporter/ Transcriber: Barbara Durand-Hollis, Telephone number: (210) 340-6464. Parties are notified of their duty to review the transcript to ensure compliance with the FRCP 5.2(a)/FRCrP 49.1(a). A

DATE FILED	DOCKET NUMBER	DOCKET TEXT
		copy may be purchased from the court reporter or viewed at the clerk's office public terminal. If redaction is necessary, a Notice of Redaction Request must be filed within 21 days. If no such Notice is filed, the transcript will be made available via PACER without redaction after 90 calendar days. The clerk will mail a copy of this notice to parties not electronically noticed Redaction Request due 10/12/2010. Redacted Transcript Deadline set for 10/22/ 2010. Release of Transcript Restriction set for 12/20/2010. (aej,) (Entered: 09/21/2010)
9/21/10	66	Transcript filed of Proceedings held on 9/14/10, Proceedings Transcribed: Bench Trial—Vol 1 Afternoon Session. Court Reporter/Transcriber: Barbara Durand-Hollis, Telephone number: (210) 340-6464. Parties are notified of their duty to review the transcript to ensure compliance with the FRCP 5.2(a)/FRCrP 49.1(a). A copy may be purchased

DATE FILED	DOCKET NUMBER	DOCKET TEXT
		from the court reporter or viewed at the clerk's office public terminal. If redaction is necessary, a Notice of Redaction Request must be filed within 21 days. If no such Notice is filed, the transcript will be made available via PACER without redaction after 90 calendar days. The clerk will mail a copy of this notice to parties not electronically noticed Redaction Request due 10/12/2010. Redacted Transcript Deadline set for 10/22/2010. Release of Transcript Restriction set for 12/20/2010. (aej,) (Entered: 09/21/2010)
9/21/10	67	Transcript filed of Proceedings held on 9/16/10, Proceedings Transcribed: Bench Trial—Vol IV Morning Session. Court Reporter/ Transcriber: Arlinda Rodriguez, Telephone number: (210) 340-6464. Parties are notified of their duty to review the transcript to ensure compliance with the FRCP 5.2(a)/FRCrP 49.1(a). A copy may be purchased from the court reporter or viewed at the clerk's

DATE FILED	DOCKET NUMBER	DOCKET TEXT
		office public terminal. If redaction is necessary, a Notice of Redaction Request must be filed within 21 days. If no such Notice is filed, the transcript will be made available via PACER without redaction after 90 calendar days. The clerk will mail a copy of this notice to parties not electronically noticed Redaction Request due 10/12/2010. Redacted Transcript Deadline set for 10/22/2010. Release of Transcript Restriction set for 12/20/2010. (aej,) (Entered: 09/21/2010)
9/21/10	68	Transcript filed of Proceedings held on 9/16/10, Proceedings Transcribed: Bench Trial—Vol 4 Afternoon Session. Court Reporter/ Transcriber: Barbara Durand-Hollis, Telephone number: (210) 340-6464. Parties are notified of their duty to review the transcript to ensure compliance with the FRCP 5.2(a)/FRCrP 49.1(a). A copy may be purchased from the court reporter or viewed at the clerk's office public terminal. If

DATE FILED	DOCKET NUMBER	DOCKET TEXT
		redaction is necessary, a Notice of Redaction Request must be filed within 21 days. If no such Notice is filed, the transcript will be made available via PACER without redaction after 90 calendar days. The clerk will mail a copy of this notice to parties not electronically noticed Redaction Request due 10/12/2010. Redacted Transcript Deadline set for 10/22/2010. Release of Transcript Restriction set for 12/20/2010. (aej,) (Entered: 09/21/2010)
9/21/10	69	ORDER Granting Defendant's Motion for Judgment as a Matter of Law. Plaintiff's brief with respect to the issue of penalties due 9/27/10; Defendant's response due 10/7/10. Signed by Judge Harry Lee Hudspeth. (tm) (Entered: 09/21/2010)

DATE FILED	DOCKET NUMBER	DOCKET TEXT
9/27/10	70	MOTION for Leave to Exceed Page Limitation by Gary Woods. (Attachments: # 1 Proposed Order, # 2 Plaintiffs' Trial Brief, # 3 Exhibit A to Plaintiffs' Trial Brief) (Crouch, Joel) (Entered: 09/27/2010)
9/27/10	71	TRIAL BRIEF by Gary Woods. (Attachments: # 1 Exhibit A) (Crouch, Joel) (Entered: 09/27/2010)
9/28/10	72	ORDER GRANTING 70 Motion for Leave to File Trial Brief in Excess Pages. Signed by Judge Harry Lee Hudspeth. (tm) (Entered: 09/29/2010)
10/7/10	73	Opposed MOTION for Leave to Exceed Page Limitation by United States. (Attachments: # 1 Proposed Order Proposed Order Granting Leave, # 2 Exhibit Proposed Brief of Defendant, # 3 Appendix Appendix A to Proposed Brief of Defendant, # 4 Appendix Appendix B to Proposed Brief of Defendant, # 5 Appendix Appendix C to Proposed Brief of De-

DATE FILED	DOCKET NUMBER	DOCKET TEXT
		fendant) (Lindquist, John) (Entered: 10/07/2010)
10/11/10	74	RESPONSE to Motion, filed by Gary Woods, re 73 Opposed MOTION for Leave to Exceed Page Limitation filed by Defendant United States (Crouch, Joel) (Entered: 10/11/2010)
10/12/10	75	MOTION to Strike *Appendix A, Appendix B, and Appendix C to the United States' Brief as to the Applicability of Accuracy-Related Penalties* by Gary Woods. (Attachments: # 1 Proposed Order) (Crouch, Joel) (Entered: 10/12/2010)
10/13/10	76	***COUNSEL REILED DOCUMENT AS NO. 77 TO CORRECT ERROR*** Response in Opposition to Motion, filed by United States, re 75 MOTION to Strike *Appendix A, Appendix B, and Appendix C to the United States' Brief as to the Applicability of Accuracy-Related Penalties* filed by Plaintiff Gary Woods (Attachments: # 1 Proposed

DATE FILED	DOCKET NUMBER	DOCKET TEXT
		Order) (Pitzinger, Joseph) Modified on 10/13/2010 (tm). (Entered: 10/13/2010)
10/13/10	77	Response in Opposition To 75 Plaintiffs' Motion to Strike Appendices by United States. (Attachments: # 1 Corrected) (Pitzinger, Joseph) Modified docket text on 10/13/2010 (tm). (Entered: 10/13/2010)
10/13/10		***Notice of Correction: re 77 Response in Opposition To Plaintiffs' Motion to Strike Appendices. Docket text was edited to reflect pleading was a reponse not a motion. Motion was terminated.*** (tm) (Entered: 10/13/2010)
10/14/10	78	ORDER GRANTING 73 Motion for Leave to File Excess Pages. Signed by Judge Harry Lee Hudspeth. (rg) (Entered: 10/14/2010)

DATE FILED	DOCKET NUMBER	DOCKET TEXT
10/14/10	79	BRIEF as to the applicability of accuracy related penalties by United States. (Attachments: # 1 Appendix A, # 2 Appendix B, # 3 Appendix C) (rf) (Entered: 10/14/2010)
1/24/11	80	NOTICE *of Recent Authority* by United States re 79 Brief (Pitzinger, Joseph) (Entered: 01/24/2011)
3/31/11	81	ORDER Regarding Objections to Accuracy-Related Penalties. Signed by Judge Harry Lee Hudspeth. (tm) (Entered: 03/31/2011)
3/31/11	82	JUDGMENT in favor of United States of America. Signed by Judge Harry Lee Hudspeth. (tm) (Entered: 03/31/2011)
4/21/11	83	MOTION to Amend Judgment by Gary Woods. (Crouch, Joel) (Entered: 04/21/2011)

DATE FILED	DOCKET NUMBER	DOCKET TEXT
4/26/11	84	Response in Opposition to Motion, filed by United States, re 83 MOTION to Amend Judgment filed by Plaintiff Gary Woods (Lindquist, John) (Entered: 04/26/2011)
4/28/11	85	BILL OF COSTS by United States. (Attachments: # 1 Exhibit A-1 Claimed Costs for Deposition Transcripts, # 2 Exhibit A-2 Claimed Costs for Trial Transcripts, # 3 Exhibit B Claimed Costs for Witness Fees, # 4 Exhibit C Claimed Costs for Making Copies) (Lindquist, John) (Entered: 04/28/2011)
5/27/11	86	NOTICE OF APPEAL by United States. Per 5th Circuit rules, the appellant has 14 days, from the filing of the Notice of Appeal, to order the transcript. To order a transcript, the appellant should fill out Form DKT-13 (Transcript Order) and follow the instructions set out on the form. This form is available in the Clerk's Office or by clicking the hyperlink above. (tm) (Entered: 05/27/2011)

DATE FILED	DOCKET NUMBER	DOCKET TEXT
6/6/11	87	TRANSCRIPT REQUEST: TRANSCRIPT IS ALREADY ON FILE IN CLERK'S OFFICE by United States (bn) (Entered: 06/06/2011)
6/8/11	88	Cross Appeal of Final Judgment 82 by Gary Woods. No filing fee submitted (Crouch, Joel) (Entered: 06/08/2011)
6/8/11	89	NOTICE OF APPEAL (Cross-Appeal) by Gary Woods. Per 5th Circuit rules, the appellant has 14 days, from the filing of the Notice of Appeal, to order the transcript. To order a transcript, the appellant should fill out Form DKT-13 (Transcript Order) and follow the instructions set out on the form. This form is available in the Clerk's Office or by clicking the hyperlink above. (tm) (Entered: 06/08/2011)
6/13/11	90	TRANSCRIPT REQUEST: TRANSCRIPT ALREADY ON FILE by Gary Woods. (bn) (Entered: 06/13/2011)

DATE FILED	DOCKET NUMBER	DOCKET TEXT
8/8/11	91	ORDER DENYING 83 Motion to Alter or Amend Judgment. Signed by Judge Harry Lee Hudspeth. (tm) (Entered: 08/08/2011)
8/18/11	92	Miscellaneous Objection to 85 Bill of Costs, by Gary Woods. (Attachments: # 1 Exhibit A) (Crouch, Joel) (Entered: 08/18/2011)
8/18/11	93	USCA Appeal Fees received $455 receipt number 500013308 re 89 Notice of Appeal, filed by Gary Woods (tm) (Entered: 08/19/2011)
8/25/11	94	RESPONSE *to Plaintiffs' Objection* to 85 Bill of Costs, 92 Miscellaneous Objection by United States. (Attachments: # 1 Affidavit Declaration of John Lindquist, # 2 Exhibit Exhibit 1, # 3 Exhibit Exhibit 2) (Lindquist, John) (Entered: 08/25/2011)
9/27/11	95	Certified Record on Appeal. Emailed on 9/27/2011 to US Court of Appeals re 89 Notice of Appeal, 86 Notice of Appeal, CASE CON-

DATE FILED	DOCKET NUMBER	DOCKET TEXT
		SOLIDATED WITH SA 05 CV 217. (Appeal record held for pickup per 5th circuit instructions.) (bn) (Entered: 09/28/2011)
9/28/11		Remark: Received (2)Boxes Defendant's EXHIBITS from John A Linquest. (bn) (Entered: 09/28/2011)
10/4/11		Remark: Received (3)black binders of Plaintiff's EXHIBITS. Re: 64 (bn) (Entered: 10/04/2011)
10/4/11	96	Supplemental Record on Appeal. E-mailed on 10/4/2011 to US Court of Appeals re 89 Notice of Appeal, 86 Notice of Appeal, (Exhibits (held with record) for pickup per 5th Circuit instructions.) (bn) (Entered: 10/05/2011)
11/3/11	97	Certified and Transmitted Record on Appeal to Arthur T. Catterall, U.S. Dept. of Justice Tax Div./ Appellant Sec. re 89 Notice of Appeal, 86 Notice of Appeal, (bn) (Entered: 11/03/2011)
11/25/11	98	Acknowledgement Receipt for Record on Appeal by Attorney,

DATE FILED	DOCKET NUMBER	DOCKET TEXT
		Arthur T Catterall. Appeal Record was FORWARDED to Joel Crouch. re 97 Appeal Record Transmitted (bn) (Entered: 11/30/2011)
12/21/11	99	Certified copy of USCA JUDGMENT/MANDATE Dismissing 88 89 Notice of Appeal (E-Filed) filed by Gary Woods. (The main appeal file on 5/27/11 by the United States remains open and the appellee's brief for Mr. Gary Woods remains due on 12/27/11.) (bn) Modified on 12/23/2011 (bn,). (Entered: 12/23/2011)
12/21/11	100	Letter of transmittal from USCA received for 88 89 Notice of Appeal, filed by Gary Woods. Copy of the judgment issued as the mandate in cross appeal filed on 6/8/11 ONLY. The original appeal fo;ed pm 5/27/11 by the United Sates remains open. Also attached is a new caption that should be used by all parties for ALL future filings. (bn) (Entered: 12/23/2011)

DATE FILED	DOCKET NUMBER	DOCKET TEXT
3/8/12	101	ORDER Regarding Defendant's Right to Recover Costs. Signed by Judge Harry Lee Hudspeth. (tm) (Entered: 03/08/2012)
3/8/12	102	ORDER Regarding Defendant's Bill of Costs. Signed by Judge Harry Lee Hudspeth. (tm) (Entered: 03/08/2012)
8/20/12	103	Certified copy of USCA JUDGMENT/MANDATE Affirming 86 Notice of Appeal, filed by United States, 89 Notice of Appeal, filed by Gary Woods. (bn) (Entered: 08/24/2012)
8/20/12	104	Appeal Record Returned/Disposed by USCA: (Noted on document) (bn) (Entered: 08/24/2012)
8/30/12	105	Letter of transmittal from USCA received for 89 Notice of Appeal, filed by Gary Woods, 86 Notice of Appeal, filed by United States.— Pursuant to the court order of 7/26/12, attached is an amended approved bill of cost. (dtg) (Entered: 09/04/2012)
9/10/12	106	Remark: Both Plaintiff's and Government's EXHIBITS WERE

DATE FILED	DOCKET NUMBER	DOCKET TEXT
		SENT TO JOSEPH A PITZINGER, Department of Justice Tax Div. (bn) (Entered: 09/11/2012)
3/27/13	107	Letter of transmittal from USCA received: Enclosed is a copy of the Supreme Court order GRANTING certiorari. for 89 Notice of Appeal, filed by Gary Woods, 86 Notice of Appeal, filed by United States. (bn) (Entered: 04/04/2013)

UNITED STATES DISTRICT COURT
FOR THE WESTERN DISTRICT OF TEXAS
SAN ANTONIO DIVISION

Case No. SA05CA0216XR

GARY WOODS, AS TAX MATTERS PARTNER OF TESORO DRIVE PARTNERS, A TEXAS GENERAL PARTNERSHIP, PLAINTIFFS

v.

UNITED STATES OF AMERICA, DEFENDANT

[Filed: Mar. 18, 2005]

PETITION FOR READJUSTMENT OF PARTNERSHIP ITEMS UNDER CODE SECTION 6226

Petitioner Tesoro Drive Partners, a Texas general partnership, and Gary Woods as Tax Matters Partner ("Petitioners") file this Petition for Readjustment of Partnership Items Under 26 U.S.C. § 6226 (the "Petition") against Defendant, The United States of America. In support of this Petition, Petitioners will show the Court as follows:

I. PETITIONERS

1. **Petitioner Tesoro Drive Partners ("TD Partners" or the "Partnership")** is a Texas general partnership. Its principal place of business is at 755 East

Mulberry, Suite 600, San Antonio, Texas 78212 and its employer identification number is 74-2936192.

2. For the tax year ending December 27, 1999, the Partnership filed its return with the Austin, Texas office of the Internal Revenue Service.

3. **GW Tesoro Investments LLC ("GW")** is a limited liability company formed under Delaware law that is wholly owned by **Gary Woods ("Woods")** and is disregarded for federal income tax purposes. GW is a 61.54% partner in TD Partners for tax year ending December 27, 1999.

4. GW is now a dissolved entity. For this reason, Gary Woods as sole members of GW files this Petition directly rather than through GW.

5. GW's address and principal place of business is 755 East Mulberry, Suite 600, San Antonio, Texas 78212, and its federal employer identification number is 74-2936194.

6. For the 1999 federal income tax year, Woods filed a joint return with his wife, Glenda M. Woods.

7. BJM Tesoro Drive Investments LLC ("BJM") is a limited liability company formed under Delaware law that is wholly owned by Billy J. McCombs ("McCombs") and is disregarded for federal income tax purposes. BJM is a 38.46% partner in TD Partners for tax year ending December 27, 1999.

8. BJM is now a dissolved entity.

9. BJM's address and principal place of business is 755 East Mulberry, Suite 600, San Antonio, Texas

78212, and its federal employer identification number is 74-2936195.

10. For the 1999 federal income tax year, McCombs filed a joint return with his wife, Charline H. McCombs.

11. Both GW and BJM are single member limited liability companies that, pursuant to Treas. Reg. § 301.7701-2(c)(2) are disregarded for federal tax purposes.

12. Woods and McCombs are collectively referred to as the **"Taxpayers"** in this Petition. GW and BJM are collectively referred to as the **"Partners"** or the **"Limited Liability Companies"** in this Petition.

13. On December 27, 2004, the Commissioner of Internal Revenue (the "Commissioner") issued a Notice of Final Partnership Administrative Adjustment ("FPAA") against TD Partners for tax year ending December 31, 1999. The Commissioner issued the FPAA from the Internal Revenue Service ("IRS") office at 316 N. Robert St., St. Paul, MN 55101. A copy of the FPAA is attached to this Petition as Exhibit "A."

14. The proposed adjustments in the FPAA would result in deficiencies for each of the Taxpayers because each Taxpayer, through his respective limited liability company, is a partner in TD Partners.

15. Petitioners are filing this Petition within ninety days after the day on which the FPAA was mailed to the tax matters partner, GW.

16. According to Sections 6226(a) of the Internal Revenue Code (the "Code"), Petitioners have standing to bring this Petition.

II. DEFENDANT

17. Respondent is The United States of America and will be served by mailing a copy of this Petition and a Summons by certified mail, return receipt requested, to (i) Johnny K. Sutton, United States Attorney for the Western District of Texas, 601 N.W. Loop 410, Ste. 600, San Antonio, TX 78216, (ii) the Honorable John Ashcroft, Attorney General of the United States, United States Department of Justice, 950 Pennsylvania Ave., N.W., Room B-324, Washington DC 20530; (iii) Tim Faulk, Revenue Agent, 316 N. Roberts Street, St. Paul Minnesota 55101; (iv) Patrick Kelly, Group Manager, Internal Revenue Service, Small Business/Self Employed Business Division, Area 9, 21 S.W. Second Street, Rm. 301, Rochester, Minnesota 55902; (v) Bert Snider, Territory Manager, 316 N. Roberts Street, St. Paul, Minnesota 55101; (vi) Kevin Harris, Territory Manager, Small Business/Self Employed Business Division, Area 9, 1222 Spruce Street, Saint Louis, Missouri 64103; and (vii) Farris R. Fink, Area 9 Director, Internal Revenue Service, Small Business/Self Employed Business Division, Area 9, 316 North Robert Street, St. Paul Minnesota 55101.

III. STATEMENT OF CASE

18. This is a civil action arising under Section 6226(a) of the Code for the redetermination of final partnership administrative adjustments to TD Partners' Form 1065 income tax return for the tax year

ended December 31, 1999, as set forth by the Commissioner in the FPAA.

19. For the tax year ended December 31, 1999, the Commissioner erroneously and illegally determined that: (a) the form of the transactions at issue should be recharacterized or disregarded under a number of different theories; (b) TD Partners should be disregarded as a partnership for federal income tax purposes; and (c) several corresponding adjustments should be made to Petitioners' tax liabilities.

IV. JURISDICTION AND VENUE

20. Code Sections 6226(a) and 28 U.S.C. § 1346(a)(1) confer jurisdiction on this Court.

21. Venue is proper in the Western District of Texas, San Antonio Division, according to Section 6226(a) and 28 USC § 1402.

22. For jurisdiction purposes, Petitioners have complied with the requirements of Code Section 6226(e) by having Woods, as the tax matters partner and sole owner of GW, deposit the amount by which his federal income tax liability, including interest, would be increased if treatment of the Partnership items on his tax returns for the tax years at issue were made consistent with the treatment of partnership items on TD Partners' tax returns as adjusted by the Commissioner in the FPAA. Petitioners have also included interest in their deposit. These deposited amounts are referred to herein as the Deposit.

23. The Deposit is in the amount of $3,993,117.00 and was remitted To the Internal Revenue Service in Austin, Texas.

24. A true and correct copy of the letter and the check sent to the IRS representing the above Deposit is attached to this Petition as Exhibit "B."

V. DESCRIPTION OF TRANSACTIONS

25. After consultation with and obtaining the advice, guidance, and counsel of qualified tax professionals, the Taxpayers entered into the following transactions (the "Transactions").

Purchase of Long and Sale of Short Options

26. On November 18, 1999, the Taxpayers, through their wholly-owned limited liability companies (collectively, the "Limited Liability Companies"), entered into certain over-the-counter, non-publicly traded European-style foreign currency option positions on the German Deutschmark and Swiss Franc (collectively the "Options") with Deutsche Bank AG New York Branch (the "Bank").

27. Each Taxpayer purchased a Long Option and sold a Short Option.

Details of Long Options

28. Woods bought a digital option on the German Deutschmark/U.S. Dollar exchange rate at a strike price of 1.9133 German Deutschmarks per U.S. $1.0 with an expiration date of December 20, 1999, a settlement date of December 22, 1999, and a pay-

off amount of $16,000,000 and paid a premium of $8,000,000.

29. McCombs bought a digital option on the Swiss Franc/U.S. Dollar exchange rate at a strike price of 1.5626 Swiss Francs per U.S. $1.0 with an expiration date of December 20, 1999, a settlement date of December 22, 1999, and a payoff amount of $10,000,000 and paid a premium of $5,000,000.

30. The options described in paragraphs 28 and 29 are referred to as the "Long Options."

Details of Short Options

31. Woods sold a digital option on the German Deutschmark/U.S. Dollar exchange rate at a strike price of 1.9135 German Deutschemarks per U.S. $1.0 and received a premium of $7,600,000 with an expiration date of December 20, 1999, a settlement date of December 22, 1999, and a payoff amount of $15,000,000.

32. McCombs sold a digital option on the Swiss Franc/U.S. Dollar exchange rate at a strike price of 1.5628 Swiss Francs per U.S. $1.0 and received a premium of $4,750,000 with an expiration date of December 20, 1999, a settlement date of December 22, 1999, and a payoff amount of$9,375,000.

33. The options described in paragraphs 31 and 32 are referred to as the "Short Options." Together the Long Options and the Short Options are referred to as the "Options."

Contribution of the Options to TD Partners

34. On November 19, 1999, the Taxpayers contributed the Options to TD Partners as contributions to capital.

Options Terminate

35. On December 17, 1999 TD Partners' option positions terminated. The date of termination was established after careful monitoring of the applicable exchange rates in order to maximize the overall return on investment.

Purchase of Foreign Currency

36. On December 22, 1999, TD Partners purchased Canadian Dollars (the "Foreign Currency") as an investment.

Contribution of Partnership Interests to TDI, Inc.

37. On December 27, 1999, Woods contributed his interest in TD Partners to Tesoro Drive Investors, Inc. ("TDI, Inc."), a Delaware corporation, in which he held a 61.54% shareholder interest.

38. On December 27, 1999, McCombs contributed his interest in TD Partners to TDI, Inc. in which he was a 38.46% shareholder.

TDI, Inc.'s Sale of the Investments in Foreign Currency

39. On December 27, 1999, TD Partners was dissolved and liquidated because each Taxpayer contributed his interest in TD Partners to TDI, Inc. Upon liquidation, all of the Foreign Currency was distributed to TDI, Inc.

40. TDI, Inc. sold all of its investments in the Foreign Currency on December 29, 1999.

41. TDI, Inc.'s sale of its investment in the Foreign Currency triggered a loss that was reported on TDI, Inc.'s 1120S and the corresponding Schedule K-1s for the 1999 tax year. The aggregate loss was in the amount of $13,353,162.

VI. 1999 TAX RETURNS

42. TD Partners timely filed its Form 1065 for the short tax year ending December 27, 1999, the date of TD Partners' dissolution. Ernst & Young LLP prepared TD Partners' tax return.

43. TDI, Inc. timely filed a Form 1120S for the tax year ending December 31, 1999. Ernst & Young LLP prepared TDI, Inc.'s tax return.

44. As required under applicable federal tax law, the Taxpayers timely filed their respective federal income tax returns for the 1999 tax year, which included their respective share of income, losses, and deductions from TDI, Inc. and TD Partners as reflected in the returns previously prepared by Ernst & Young LLP.

45. The loss generated by TDI, Inc.'s sale of the Foreign Currency was allocated to the limited liability companies owned by the Taxpayers on their respective K-1s for the 1999 tax year as follows: (a) $8,217,536 was allocated to Woods; and (b) $5,135,626 was allocated to McCombs.

VII. RELIANCE ON TAX PROFESSIONALS

46. Petitioners sought the advice, counsel, and guidance of competent tax professionals, including but not limited to, professionals at Jenkens & Gilchrist P.C., Brown & Wood LLP, and Ernst & Young LLP in determining the federal income tax consequences and proper reporting obligations relative to the Transactions described in Section V above before filing their respective federal income tax returns.

47. The Taxpayers have utilized the services of Ernst & Young LLP since at least the mid to late Eighties in connection with accounting, audit, tax and investment matters. Over the years, the Taxpayers, as businessmen, venture capitalists and entrepreneurs, have established a strong business and personal relationship with various individuals at Ernst & Young LLP.

48. The Taxpayers were introduced to the Transactions by representatives of Ernst & Young LLP with whom the Taxpayers had a long-standing personal and business relationship. These representatives presented the Transactions as sound and legal business investments, both before and after tax considerations were taken into account.

49. Ernst & Young LLP ultimately provided advice regarding all aspects of the Transactions, including profit potential, investment strategy, choice of entities, business structure, accounting and tax reporting.

50. Based on the information and guidance provided by professionals at Ernst & Young, the Taxpay-

ers at all times regarded the Transactions as investments carrying the potential for generating significant profits, independent of any tax benefits.

51. As with all other advice and services provided by Ernst & Young over the years, the Taxpayers have at all times considered Ernst & Young LLP to be a qualified and independent professional entity having no interest in the Transactions other than in the capacity of providing professional investment, accounting and tax advice.

52. At the suggestion of Ernst & Young, the Taxpayers each obtained a separate written legal opinion from Jenkens & Gilchrist P.C. dated January 31, 2000 (collectively, the "Jenkens Opinions"). In the Jenkens Opinions, Jenkens & Gilchrist P.C. provided an opinion on a more likely than not basis regarding the federal tax consequences of the Transactions as ratified by the other opinions received and the positions taken on the federal tax returns by Ernst & Young LLP. The conclusions set forth in the Jenkens Opinions provided the bases for the manner in which the Transactions were reported for federal tax purposes.

53. The Jenkens Opinions were provided to the Taxpayers before they filed their federal income tax returns for the 1999 tax year.

54. The Jenkens Opinions conclude it is more likely than not that:

(a) Each of the Limited Liability Companies, as a single member limited liability company, should be

disregarded as an entity for federal income tax purposes;

(b) Investing in the Options should not be taxable, and the Options should be treated as separate instruments for federal income tax purposes;

(c) TD Partners should be classified as a partnership for federal income tax purposes;

(d) The Taxpayers' contributions of their respective Options to TD Partners should not result in a taxable gain or loss;

(e) The Short Options should not be liabilities within the meaning of Code Section 752 as amended;

(f) Each of the Partners' basis in TD Partners after contribution of their respective Options should include the cost of the Long Option contributed, without adjustment for the Short Option;

(g) An adjustment to each of the Partners' adjusted basis in their respective partnership interests should be required as a result of the expiration of the Option, due to the recognition of ordinary income on such expiration under Code Section 1234;

(h) Contribution by each of the Partners of their respective interest in TD Partners to TDI, Inc. should not be a taxable transaction, and TDI, Inc.'s basis in the partnership interest contributed by the Partners should be equal to their basis in such interests as of the date of such contribution;

(i) Each of the Partners' basis in their interest in TDI, Inc. should be increased by an amount equal to

the adjusted basis of their interest in TD Partners as of the date of contribution;

(j) The liquidation of TD Partners should not result in gain or loss recognition;

(k) The liquidation of TD Partners should result in an allocation of TD Partners' "outside" basis to the properties distributed by it in the liquidation, which consisted of cash and an investment in the Foreign Currency in this case;

(l) The disposition by TDI, Inc. of all the Foreign Currency received in liquidation of TD Partners should result in an ordinary loss;

(m) The step transaction and sham transaction doctrines should not apply to the Transactions;

(n) Code Sections 707(a)(2)(B), 165(c), 465, 469, and 1092 should not apply to the Transactions; and

(o) Treasury Regulation Section 1.701-2 should not apply to the Transactions.

55. Thereafter, the Taxpayers each obtained corroborating written legal opinions from Brown & Wood, LLP (the "BW Opinions"). Collectively the Jenkens Opinions and the BW Opinions are referred to as the "Legal Opinions."

56. Petitioners relied on their various long tern tax advisors at Ernst & Young LLP as well as on the Legal Opinions to determine and advise Petitioners regarding the tax consequences of the Transactions. This reliance was reasonable and in good faith.

VIII. COMMISSIONER'S ERRORS IN FPAA

57. Petitioners incorporate paragraphs 1 through 56 as though fully set forth here.

58. The Commissioner erred in determining that:

(a) The ordinary income of the Partnership should be decreased by $650,000 for the tax year ending December 31, 1999.

(b) The net short-term capital gain of the Partnership should be decreased by $5,037 for tax year ending December 31, 1999.

(c) Neither TD Partners nor its Partners have established the existence of TD Partners as a partnership as a matter of fact.

(d) Even if TD Partners existed as a partnership, it was formed and availed of solely for purposes of tax avoidance by artificially overstating basis in the partnership interests of its Partners.

(e) The formation of TD Partners, the acquisition of any interest in the partnership by the Partners, the purchase of offsetting options, the transfer of offsetting options to the Partnership in return for a partnership interest, the purchase of assets by the Partnership, and the distribution of those assets to TDI, Inc. in complete liquidation of the partnership interests, and the subsequent sale of those assets to generate a loss, all within a period of less than two months, had no business purpose other than tax avoidance, lacked economic substance, and, in fact and substance,

constitutes an economic sham for federal income tax purposes.

(f) The Partnership and the Transactions shall be disregarded in full and any purported losses resulting from these Transactions are not allowable as deductions.

(g) TD Partners was a sham, lacked economic substance, and, under Treas. Reg. § 1.701-2, was formed and availed of in connection with a transaction or transactions in taxable year November 18 to December 27, 1999, a principal purpose of which was to reduce substantially the present value of its Partners' aggregate federal tax liability in a manner that is inconsistent with the intent of Subchapter K of the Internal Revenue Code.

(h) TD Partners is disregarded and all transactions engaged in by the Partnership are treated as engaged in directly by its Partners. This includes the determination that the assets purportedly acquired by TD Partners, including, but not limited to, the Options, were acquired directly by the Partners.

(i) The Options contributed to or assumed by TD Partners, are treated as never having been contributed to or assumed by the Partnership and any gains or losses realized by TD Partners on the Options are treated as having been realized by its Partners.

(j) The Partners of TD Partners should be treated as not being partners in TD Partners.

(k) Contributions to TD Partners will be adjusted to reflect clearly the Partnership's or Partners' income.

(l) The obligations under the short positions (written call options) transferred to TD Partners constitute liabilities for purposes of Treas. Reg. § 1.752-6T, the assumption of which by TD Partners shall reduce the Partners' bases for GW and BJM in TD Partners in the amount of $7,600,000 and $4,750,000, respectively, but not below the fair market value of the partnership interest.

(m) Neither TD Partners nor its Partners entered into the Options or the investments in Foreign Currency with a profit motive for purposes of Code Section 165(c)(2).

(n) Even if the Options are treated as having been contributed to TD Partners, the amount treated as contributed by the Partners under Code Section 722 is reduced by the amounts received by the contributing Partners from the contemporaneous sales of the call options to the same counter-party.

(o) The basis of the Options is reduced, both in the hands of the contributing Partners and TD Partners. Consequently, any corresponding claimed increases in the outside basis in TD Partners resulting from the contributions of the Options are disallowed.

(p) The adjusted bases of the long call positions (purchased call options) and other contributions made by the Partners to TD Partners have not been established under Code Section 723.

(q) The Partners of TD Partners have not established adjusted bases in their respective partnership interests in an amount greater than zero (-0-).

(r) In the case of a sale, exchange, or liquidation of TD Partners' partnership interests, neither the Partnership nor its Partners have established that the bases of the Partners' partnership interests were greater than zero for purposes of determining gain or loss to such Partners from the sale, exchange, or liquidation of such partnership interest.

(s) The adjustments of partnership items of TD Partners are attributable to a tax shelter for which no substantial authority has been established for the position taken, and for which there was no showing of reasonable belief by the Partnership or its partners that the position taken was more likely than not the correct treatment of the tax shelter and related transactions.

(t) In addition, all of the underpayment of tax resulting from those adjustments of partnership items are attributable to, at a minimum, (1) substantial understatements of income tax, (2) gross valuation misstatement(s), or (3) negligence or disregarded rules or regulations.

(u) There has not been a showing by the Partnership or any of its Partners that there was reasonable cause for any of the resulting underpayments, that the Partnership or any of its Partners acted in good faith, or that any other exceptions to the penalty apply.

(v) At a minimum, the accuracy-related penalty under Section 6662(a) of the Internal Revenue Code

applies to all underpayment of tax attributable to adjustments of partnership items of the Partnership.

(w) A 40 percent penalty under Sections 6662(a), 6662(b)(3), 6662(e), and 6662(h) of the Code should be imposed on the portion of any underpayment attributable to a gross valuation misstatement.

(x) A 20 percent penalty under Sections 6662(a), 6662(b)(l) and 6662(c) of the Code should be imposed on the portion of any underpayment attributable to negligence or disregard of rules and regulations.

(y) A 20 percent penalty under Sections 6662(a), 6662(b)(2), and 6662(d) of the Code should be imposed on the portion of any underpayment attributable to a substantial understatement of income tax.

(z) A penalty of 20 percent under Sections 6662(a), 6662(b)(3), and 6662(e) of the Code should be imposed on the portion of any underpayment attributable to a substantial valuation misstatement.

59. The Commissioner erred in making each and every adjustment in the FPAA.

IX. VALIDITY OF FINAL PARTNERSHIP ADMINISTRATIVE ADJUSTMENT

60. Petitioners incorporate paragraphs 1 through 59 as though fully set forth here.

61. The FPAA is invalid because it relates to a tax year that does not exist. SATI Partners dissolved as of December 27, 1999 and does not have a tax year ending December 31, 1999.

X. TD PARTNERS CORRECT TREATMENT OF TAX ITEMS

62. Petitioners incorporate paragraphs 1 through 61 as though fully set forth herein.

63. Petitioners properly determined all items of income, losses, deductions, and credits of TD Partners for the tax year ending December 27, 1999.

64. Petitioners properly calculated and reported the net short term capital gain of TD Partners in the amount of $5,037 for tax year ending December 27, 1999.

65. Petitioners properly calculated and reported ordinary income of TD Partners in the amount of $650,000 for tax year ending December 27, 1999.

66. Taxpayers properly determined the Partners' outside basis in TD Partners for tax year ending December 27, 1999.

67. TD Partners is a partnership validly created, existing, and recognized for all state and federal law purposes, including federal income tax purposes for tax year ending December 27, 1999.

68. TD Partners was not a sham for federal income tax purposes for tax year ending December 27, 1999.

69. TD Partners did not lack economic substance for federal income tax purposes for tax year ending December 27, 1999.

70. No part of the Partnership or the Transactions may be disregarded, ignored or recharacterized on the basis that they lacked economic substance, business

purpose or otherwise constituted a sham for federal income tax purposes.

71. The losses and other benefits claimed by the Petitioners on their federal tax returns cannot be disallowed on the basis that either the Transactions or any of the entities involved constituted shams or lacked business purpose or economic substance because none of these doctrines is incorporated into or otherwise a part of the Code.

72. Disallowance of the losses or other benefits claimed by the Petitioners in this case on the basis of either the sham transaction, business purpose or economic substance theories asserted by the Commissioner would violate the separation of powers provisions of the United States Constitution.

73. TD Partners was not formed or availed of in connection with a transaction or transactions in a manner inconsistent with the intent of Subchapter K of the Code and may not otherwise be disregarded, nor may any of its transactions be recharacterized, in whole or in part, under the authority of Treas. Reg. § 1.701-2 for tax year ending December 27, 1999.

74. Treas. Reg. § 1.701-2 is invalid and inapplicable to the facts of this case.

75. The obligations under the Short Options sold do not constitute liabilities under Code Section 752. Consequently, TD Partners' assumption of those obligations is not regarded as a distribution of money to the Partners under the Code for tax year ending December 27, 1999.

76. Even if the Options do constitute liabilities under Code Section 752 and the applicable regulations, the amount of the "liability" transferred to the Partnership under the Options is $0. As such, the Partners' bases in the Partnership cannot be reduced by any part of the Options transferred to the Partnership.

77. The amounts treated as contributed by the Partners under Section 722 of the Internal Revenue Code are not reduced by the amounts received by the Partners from the sale of the Short Options.

78. Temporary Treas. Reg. 1.752-6T is invalid and inapplicable to the facts of this case.

79. Code Section 165(c)(2) does not operate to disallow the losses or other tax benefits claimed by the Partners in this case for tax year ending December 27, 1999.

80. Petitioners properly determined and reported the basis of the Foreign Currency transferred from TD Partners to TDI, Inc. for tax year ending December 27, 1999.

81. In every other respect, the federal tax consequences of the transactions at issue in this case are as set forth in the Legal Opinions discussed above and as reported by Petitioners on their federal tax returns.

82. Petitioners are not subject to penalties under Code Section 6662 because any tax liability ultimately determined by this Court against them is not attributable to: (a) negligence or disregard or rules or regulations; (b) any substantial understatement of income

tax; or (c) any substantial or gross valuation misstatement under Chapter 1.

83. Petitioners are not subject to penalties under Code Section 6662 because any understatement ultimately determined by the Court is attributable to items for which the relevant facts were adequately disclosed in Petitioners' returns or in a statement attached to the returns; and there is a reasonable basis for the tax treatment of such item by the taxpayer.

84. The Transactions at issue in this case do not constitute a tax shelter.

85. In the alternative, even if the Transactions do constitute a tax shelter, Petitioners are not subject to penalties under Code Section 6662 because any understatement ultimately determined by the Court is, based on the foregoing, attributable to the tax treatment of items for which there is or was substantial authority for such treatment, and, furthermore, Petitioners reasonably believed that the tax treatment of such item by Petitioners was more likely than not the proper treatment.

86. Petitioners are not subject to penalties under Code Section 6662(b)(1) because they were not negligent nor did they disregard any rules or regulations as contemplated by Code Section 6662.

87. Petitioners are not subject to penalties under Code Section 6662(b)(2) because there is no substantial understatement of income tax as contemplated by Section 6662.

88. Petitioners are not subject to penalties under Code Section 6662(b)(3) because there is no substantial or gross valuation misstatement as contemplated by Code Section 6662.

89. Petitioners are not subject to penalties under Code Section 6662 on any underpayment ultimately determined because there was, based on the foregoing, reasonable cause for such underpayment and Petitioners acted in good faith as contemplated by Code Section 6664(c)(1).

90. Petitioners relied on the advice provided by tax professionals including, but not limited to, Jenkens & Gilchrist, P.C., Brown & Wood, LLP and Ernst & Young, LLP. In addition, the reliance on such advice was reasonable and in good faith. Thus, under the authority of Code Section 6664(c)(1) and Treasury Regulation § 1.6664-4, Petitioners are not subject to the penalties imposed by the IRS under Code Section 6662.

XI. PRAYER

Petitioners respectfully pray for judgment against Defendant and respectfully ask the Court to declare the FPAA invalid or alternatively to order Defendant to reverse the adjustments set forth in the FPAA. Petitioners further pray that the Court order Defendant to return the Deposit plus interest to Woods. Petitioners also request that the Court grant them such further relief, legal or equitable, to which they may be entitled.

Respectfully submitted,

By: /s/ JOEL N. CROUCH
JOEL N. CROUCH
Texas State Bar No. 05144220
M. Todd Welty
Texas State Bar No. 00788642

MEADOWS, OWENS, COLLIER, REED, COUSINS & BLAU, L.L.P.
901 Main Street, Suite 3700
Dallas, TX 75202
(214) 744-3700 Telephone
(214) 747-3732 Facsimile
twelty@meadowsowens.com
jcrouch@meadowsowens.com

ATTORNEYS-IN-CHARGE FOR PETITIONERS

Internal Revenue Service

316 North Robert Street
St. Paul, Minnesota 55101

Date: [Dec. 21, 2004]

Tax Matters Partner
Tesoro Drive Partners
755 East Mulberry, Suite 600
San Antonio, TX 78212

Department of the Treasury

Refer To:
ESB Stop 4020BK

Taxpayer Identifying Number:
74-2936193

Name of Partnership:
Tesoro Drive Partners

Partnership Identifying Number:
74-2936193

Tax Year Ended:
December 31, 1999

Date FPAA Mailed to Tax Matters Partner:
[Dec. 21, 2004]

Person to Contact:
Bill Kahnke
41-03606

Contact Hours:
8:00 a.m. to 4:30 p.m.

Contact Telephone Number:
(651) 312-7909

NOTICE OF FINAL PARTNERSHIP ADMINSTRATIVE ADJUSTMENT

The law requires us to send a Notice of Final Partnership Administrative Adjustment (FPAA) to the partnership named above, for the tax year shown above, and to each partner who is entitled to receive this notice.

We are proposing adjustments to the partnership items of the partnership and tax year shown above. We will send the examination report outlining these adjustments to the Tax Matters Partner (TMP) of the partnership. (The TMP is the partner designated by the partnership to deal with the IRS.) He/she is also authorized to act for the partners who are not entitled to receive this notice. Any partner who wants a copy of the examination report should request it from the TMP. If the TMP is unable to provide you with a copy of the examination report, please contact the person named in the heading of this letter.

Taxable Years Ending Before August 6, 1997:

The adjustments to the partnership items reported on the partnership tax return may cause an increase or decrease to the tax liability on your individual return. Form 870-P, *Agreement to Assessment and Collection of Deficiency in Tax for Partnership Adjustments*, is a summary of the proposed adjustments to the partnership return. You can compute your share of the proposed adjustments by multiplying each adjusted part-

nership item by your percentage interest for that partnership item.

Taxable Years Ending After August 5, 1997:

The adjustments to the partnership items reported on the partnership tax return may cause an increase or decrease in the tax liability on your individual return. The adjustments may include partnership level determinations regarding penalties and additions to tax that relate to adjustments to partnership items. Form 870-PT, *Agreement for Partnership Items and Partnership Level Determinations as to Penalties, Additions to Tax, and Additional Amounts,* is a summary of the proposed adjustments for that partnership item. You can compute your share of the proposed adjustments by multiplying each adjusted partnership item by your percentage interest for that partnership item.

You have three options available to you:

1. **If you agree with the adjustments:**

Sign and return the enclosed Form 870-P/Form 870-PT. When you sign Form 870-P/Form 870-PT, you are agreeing to pay any additional tax and interest resulting from the adjustments to the partnership return. For tax years ending after August 5, 1997, you are also agreeing to any partnership level determination as to penalties, additions to tax and additional amounts that relate to adjustments to partnership items, if any In addition, you are waiving your rights to participate in any administrative or judicial proceeding affecting partnership items and in partnership level determinations as to penalties, additions to tax and

additional amounts that relate to adjustments to partnership items for the tax year in question. This is a binding settlement only if you sign and return Form 870-P/Form 870-PT and we sign on behalf of the Commissioner of Internal Revenue Service. When we sign the agreement form, the one-year extension of the period of limitations on assessments will begin under Internal Revenue Code section 6229(f). Once the agreement is signed by both parties, you may not file a claim to change the items in question or claim a refund/credit based on a readjustment.

Note: If you are the TMP of the partnership, see this section of this letter entitled, "*For the Tax Matters Partner of the Partnership*".

2. **If you do not agree with the adjustments:**

If you are the TMP of the partnership and want to contest the adjustments in court, you must file a petition within 90 days from the date of this letter. During this 90-day period, no other partner may file a petition for judicial review. You can file your petition for readjustment of partnership items with:

1. the United States Tax Court;
2. the United States Court of Federal Claims; or
3. the District Court of the United States, in the district of the partnership's principal place of business.

A petition filed by the TMP precludes all other actions. If the TMP doesn't file a petition by the 90th day from the date the FPAA was mailed, any partner

or any 5 percent group entitled to receive this notice may petition one of these courts. A "5 percent group" includes any group of partners who together have an interest of five percent or more in profits of the partnership. The petition must be filed after the 90th day, but on or before the 150th day from the date the FPAA was mailed to the TMP. If more than one petition is filed in Tax Court, the first petition filed will go forward. All other petitions (even those filed earlier in one of the other courts) will be dismissed. If no one files a petition in Tax Court, the first petition filed in one of the other courts will go forward and subsequent petitions will be dismissed.

Petitions filed with the United States Tax Court must be mailed to:

United States Tax Court
400 Second Street, NW
Washington, DC 20217

Attach a copy of this letter to the petition. The time in which you must file a petition with the court is fixed by law and the court cannot consider your case if your petition is filed late. If this letter is addressed to both a husband and wife and both want to petition the Tax Court, both must sign the petition or each must file a separate signed petition.

When a partner (including each member of a 5 percent group that files a petition) files a petition in either the appropriate District Court or the Court of Federal Claims, the partner filing the petition must deposit the amount that the partner's tax liability would be increased if the treatment of the partnership

items on the partner's return were made consistent with the treatment of partnership items under the FPAA. If you reported the partnership items the way the partnership reported them on its return, you can generally determine the amount to deposit by taking your pro rata share of the partnership adjustments into account in recomputing your tax. You must deposit the appropriate amount with the IRS on or before the day you file your petition.

3. If you do nothing:

If a petition for readjustment is not filed in any of the courts listed in this letter, the FPAA becomes final, and we will bill you for any additional tax plus interest that you may owe under the FPAA. You will not be permitted to contest the treatment of the partnership items of the partnership under the FPAA in any refund claim or suit. The law allows the Service to bill you after 150 days from the mailing date of the FPAA to the TMP.

However, if a petition is filed in the Tax Court, and the Tax Court upholds the adjustments in whole or in part, we will not bill you until the Tax Court decision is final.

You may wish to contact the TMP of the partnership or your tax advisor to discuss this matter.

If you have any questions, please write to the person whose name and address are shown in the heading of this letter. If you write, attach a copy of this letter to help identify your account. Also, include your tele-

phone number and the most convenient time for us to call you in case we need additional information.

If you prefer, you may call the IRS contact person at the telephone number shown in the heading of this letter. If this number is outside your local calling area, there will be a long distance charge to you.

Thank you for your cooperation.

Sincerely,

/s/ KEVIN HARRIS
KEVIN HARRIS [BK]
Technical Services Territory Manager,
Midwest Area

Enclosures:
Form 870-P/Form 870-PT
Copy of this letter

FOR THE TAX MATTERS PARTNER OF THE PARTNERSHIP

If you are the Tax Matters Partner (TMP), you are entitled to make an agreement to bind non-notice partners to the treatment of the partnership items as shown on the enclosed schedule of adjustments. You must add the following statement above the signature blocks on the Form 870-P or Form 870-PT:

"The undersigned Tax Matters Partner is signing this offer on behalf of himself (herself) and all other partners whom, he (she) has the authority to bind; a final agreement resulting from the co-signature of the Commissioner of Internal Revenue will be binding on all such other partners."

As the TMP, you may submit a petition, as described above for the partnership on behalf of all partners.

If you have any questions, you can call the IRS contact person at the telephone number shown in the heading of this letter. Thank you for your cooperation.

Internal Revenue Service

316 North Robert Street
St. Paul, Minnesota 55101

Date: [Dec. 21, 2004]

Tax Matters Partner
Tesoro Drive Partners
755 East Mulberry, Suite 600
San Antonio, TX. 78212

Department of the Treasury

Refer To:
ESB Stop 4020BK
Taxpayer Identifying Number:
74-2936193
Name of Partnership:
Tesoro Drive Partners
Partnership Identifying Number:
74-2936193
Tax Year Ended:
December 31, 1999
Date FPAA Mailed to Tax Matters Partner:
[Dec. 21, 2004]

Person to Contact:
Bill Kahnke
41-03606

Contact Hours:
8:00 am to 4:30 pm

Contact Telephone Number:
(651) 312-7909

NOTICE OF FINAL PARTNERSHIP ADMINSTRATIVE ADJUSTMENT

The law requires us to send a Notice of Final Partnership Administrative Adjustment (FPAA) to the partnership named above, for the tax year shown above, and to each partner who is entitled to receive this notice.

We are proposing adjustments to the partnership items of the partnership and tax year shown above. We will send the examination report outlining these adjustments to the Tax Matters Partner (TMP) of the partnership. (The TMP is the partner designated by the partnership to deal with the IRS.) He/she is also authorized to act for the partners who are not entitled to receive this notice. Any partner who wants a copy of the examination report should request it from the TMP. If the TMP is unable to provide you with a copy of the examination report, please contact the person named in the heading of this letter.

Taxable Years Ending Before August 6, 1997:

The adjustments to the partnership items reported on the partnership tax return may cause an increase or decrease to the tax liability on your individual return. Form 870-P, *Agreement to Assessment and Collection of Deficiency in Tax for Partnership Adjustments*, is a summary of the proposed adjustments to the partnership return. You can compute your share of the proposed adjustments by multiplying each adjusted partnership item by your percentage interest for that partnership item.

Taxable Years Ending After August 5, 1997:

The adjustments to the partnership items reported on the partnership tax return may cause an increase or decrease in the tax liability on your individual return. The adjustments may include partnership level determinations regarding penalties and additions to tax that relate to adjustments to partnership items. Form 870-PT, *Agreement for Partnership Items and Partnership Level Determinations as to Penalties, Additions to Tax, and Additional Amounts*, is a summary of the proposed adjustments for that partnership item. You can compute your share of the proposed adjustments by multiplying each adjusted partnership item by your percentage interest for that partnership item.

You have three options available to you:

1. **If you agree with the adjustments:**

Sign and return the enclosed Form 870-P/Form 870-PT. When you sign Form 870-P/Form 870-PT, you are agreeing to pay any additional tax and interest resulting from the adjustments to the partnership return. For tax years ending after August 5, 1997, you are also agreeing to any partnership level determination as to penalties, additions to tax and additional amounts that relate to adjustments to partnership items, if any. In addition, you are waiving your rights to participate in any administrative or judicial proceeding affecting partnership items and in partnership level determinations as to penalties, additions to tax and additional amounts that relate to adjustments to partnership items for the tax year in question. This is a binding settlement only if you sign and return

Form 870-P/Form 870-PT and we sign on behalf of the Commissioner of Internal Revenue Service. When we sign the agreement form, the one-year extension of the period of limitations on assessments will begin under Internal Revenue Code section 6229(f). Once the agreement is signed by both parties, you may not file a claim to change the items in question or claim a refund/credit based on a readjustment.

Note: If you are the TMP of the partnership, see the section of this letter entitled, "*For the Tax Matters Partner of the Partnership*".

2. **If you do not agree with the adjustments:**

If you are the TMP of the partnership and want to contest the adjustments in court, you must file your petition within 90 days from the date of this letter. During this 90-day period, no other partner may file a petition for judicial review. You can file your petition for readjustment of partnership items with:

1. the United States Tax Court;
2. the United States Court of Federal Claims; or
3. the District Court of the United States, in the district of the partnership's principal place of business.

A petition filed by the TMP precludes all other actions. If the TMP doesn't file a petition by the 90th day from the date the FPAA was mailed, any partner or any 5 percent group entitled to receive this notice may petition one of these courts. A "5 percent group" includes any group of partners who together have an

interest of five percent or more in profits of the partnership. The petition must be filed after the 90th day, but on or before the 150th day from the date the FPAA was mailed to the TMP. If more than one petition is filed in Tax Court, the first petition filed will go forward. All other petitions (even those filed earlier in one of the other courts) will be dismissed. If no one files a petition in Tax Court, the first petition filed in one of the other courts will go forward and subsequent petitions will be dismissed.

Petitions filed with the United States Tax Court must be mailed to:

United States Tax Court
400 Second Street, NW
Washington, DC 20217

Attach a copy of this letter to the petition. The time in which you must file a petition with the court is fixed by law and the court cannot consider your case if your petition is filed late. If this letter is addressed to both a husband and wife and both want to petition the Tax Court, both must sign the petition or each must file a separate signed petition.

When a partner (including each member of a 5 percent group that files a petition) files a petition in either the appropriate District Court or the Court of Federal Claims, the partner filing the petition must deposit the amount that the partner's tax liability would be increased if the treatment of the partnership items on the partner's return were made consistent with the treatment of partnership items under the FPAA. If you reported the partnership items the way the part-

nership reported them on its return, you can generally determine the amount to deposit by taking your pro rata share of the partnership adjustments into account in recomputing your tax. You must deposit the appropriate amount with the IRS on or before the day you file your petition.

3. **If you do nothing:**

If a petition for readjustment is not filed in any of the courts listed in this letter, the FPAA becomes final, and we will bill you for any additional tax plus interest that you may owe under the FPAA. You will not be permitted to contest the treatment of the partnership items of the partnership under the FPAA in any refund claim or suit. The law allows the Service to bill you after 150 days from the mailing date of the FPAA to the TMP.

However, if a petition is filed in the Tax Court, and the Tax Court upholds the adjustments in whole or in part, we will not bill you until the Tax Court decision is final.

You may wish to contact the TMP of the partnership or your tax advisor to discuss this matter.

If you have any questions, please write to the person whose name and address are shown in the heading of this letter. If you write, attach a copy of this letter to help identify your account. Also, include your telephone number and the most convenient time for us to call you in case we need additional information.

If you prefer, you may call the IRS contact person at the telephone number shown in the heading of this

letter. If this number is outside your local calling area, there will be a long distance charge to you.

Thank you for your cooperation.

Sincerely,

/s/ KEVIN HARRIS
KEVIN HARRIS [BK]
Technical Services Territory
Manager, Midwest Area

Enclosures:
Form 870-P/Form 870-PT
Copy of this letter

FOR THE TAX MATTERS PARTNER OF THE PARTNERSHIP

If you are the Tax Matters Partner (TMP), you are entitled to make an agreement to bind non-notice partners to the treatment of the partnership items as shown on the enclosed schedule of adjustments. You must add the following statement above the signature blocks on the Form 870-P or Form 870-PT:

"The undersigned Tax Matters Partner is signing this offer on behalf of himself (herself) and all other partners whom, he (she) has the authority to bind; a final agreement resulting from the co-signature of the Commissioner of Internal Revenue will be binding on all such other partners."

As the TMP, you may submit a petition, as described above for the partnership on behalf of all partners.

If you have any questions, you can call the IRS contact person at the telephone number shown in the heading of this letter. Thank you for your cooperation.

Form 870-PT (8-2004)	DEPARTMENT OF THE TREASURY – INTERNAL REVENUE SERVICE **Agreement for Partnership Items and Partnership Level Determinations as to Penalties, Additions to Tax, and Additional Amounts**	IN REPLY REFER TO: ESS Stop 4020

Taxpayer(s) name(s), address and ZIP code:	Name of Partnership:	Tax Year(s) Ended:
Tax Matters Partner Tesoro Drive Partners 755 East Mulberry, Suite 500 San Antonio, TX 78212	Tesoro Drive Partners Taxpayer Identifying Number 74-2935193	December 31, 1998
Taxpayer Identifying Number: 74-2935193	Name of Tax Matters Partner:	

Offer of Agreement to Partnership Items and Partnership Level Determinations as to Penalties, Additions to Tax, and Additional Amounts
&
Waiver of Restrictions on Assessment for Partnership Items, Penalties, Additions to Tax, and Additional Amounts

Under sections 6224(c) and 7121 of the Internal Revenue Code (IRC) of 1986, the Commissioner of the Internal Revenue Service and the undersigned taxpayer(s) agree to the determination of partnership items and partnership level determinations as to penalties, additions to tax, and additional amounts that relate to adjustments to partnership items as shown on the attached schedule of adjustments.

The undersigned taxpayer(s), in accordance with IRC sections 6224(b) and 6213(d), also waive the restrictions provided by IRC sections 6225(a) and 6213(a) and consent to the assessment and collection of any deficiency attributable to partnership items, penalties, additions to tax, and additional amounts that relate to partnership items, as determined in this agreement; plus any interest provided by law.

This agreement is conditional and will not become effective or final until this agreement form is returned to the Commissioner and is signed on his or her behalf. The one-year extension of the period of limitations on assessments under IRC section 6229(f) will not begin to run until the date the Commissioner's representative signs this form on the Commissioner's behalf. If this is a partial agreement, the period of limitations for assessing any tax attributable to the settled items shall be determined as if this agreement had not been entered into.

If this part of this agreement form is signed for the Commissioner, the treatment of partnership items and partnership level determinations as to penalties, additions to tax and additional amounts that relate to adjustments to partnership items under this agreement will not be reopened in absence of fraud, malfeasance, or misrepresentation of fact. In addition, no claim for an adjustment of partnership items, refund or credit based on any change in the treatment of partnership items or partnership level determinations as to penalties, additions to tax and additional amounts may be filed or prosecuted.

Signature of Taxpayer	Date Signed
Signature of Taxpayer	Date Signed
By (Signature and Title)	Date Signed

FOR INTERNAL REVENUE USE ONLY	Date accepted for Commissioner	Signature
	Office	Title

Cat. No. 27315H — Form 870-PT (8-2004)

198.0029

INSTRUCTIONS FOR SIGNING FORM 870-PT

1. If a JOINT RETURN OF A HUSBAND AND WIFE was filed and both spouses intend to agree, both spouses should sign Form 870-PT. One spouse may sign as agent for the other if acting under a power of attorney, which, if not previously filed, must accompany this form. The IRS may accept the signature of only one spouse at its discretion. However, the agreement will only be binding on the signing spouse.

2. If the taxpayer is a corporation, the agreement should be signed with the corporate name followed by the signature and title of the officer authorized to sign Form 870-PT.

3. Your attorney or agent may sign for you if this action is specifically authorized by a power of attorney, which if not previously filed, must accompany this form.

4. If this offer is signed by a trust, the agreement must be signed with the trust name, followed by the signature and title of the person authorized to sign on behalf of the trust.

5. If this offer is with respect to the tax liability for the consolidated return year, the agreement should be signed in the name of the common parent of the consolidated group for the consolidated return year. The common parent corporation signs the agreement in its own name. The signature and title of a current officer of the common parent corporation, who is authorized to bind the corporation, should be displayed in the signature block.

6. If the Tax Matters Partner signs this offer, please include the title with the signature.

7. If this offer is signed by a Tax Matters Partner that is a subsidiary corporation, then an officer authorized to sign this agreement for the year(s) indicated on the form must sign for the parent corporation. An authorized officer for the subsidiary corporation should also sign if the Tax Matters Partner is binding non-notice partners under the agreement. See Treas. Reg. 1.1502-77(a)(3)(v).

DEPARTMENT OF THE TREASURY - INTERNAL REVENUE SERVICE

Agreement for Partnership Items and Partnership Level Determinations as to Penalties, Additions to Tax, and Additional Amounts

SCHEDULE OF ADJUSTMENTS

NAME OF PARTNERSHIP	TAX YEAR(S) ENDED		
Tesoro Drive Partners	December 31, 1999		
TAXPAYER IDENTIFYING NUMBER: 74-2936193			
DETAIL OF ADJUSTMENTS TO ORDINARY INCOME			
a. Net Gain (Loss) from Form 4797, Part II, Line 18	(650,000.00)		
TOTAL ADJUSTMENTS TO ORDINARY INCOME	(650,000.00)		
OTHER ADJUSTMENTS			
A. Outside Partnership Basis			
(1) ADJUSTMENT	*		
(2) AS REPORTED	*		
(3) CORRECTED	*		
B. Net Short-Term Capital Gain (Loss)			
(1) ADJUSTMENT	(5,037.00)		
(2) AS REPORTED	5,037.00		
(3) CORRECTED	0.00		

REMARKS

- **Reference Exhibit A attached.**

Accuracy Penalties under IRC Section 6662 are included as a partnership level determination. See Exhibit A, Paragraph B, for a description of the penalties.

EXHIBIT A—Explanation of Items
Tesoro Drive Partners
Final Partnership Administrative Adjustment Letter
Tax Year: November 18 to December 27, 1999
EIN: 74-2936193

1. It is determined that neither **Tesoro Drive Partners** nor its purported partners have established the existence of **Tesoro Drive Partners** as partnership as a matter of fact.

2. Even if **Tesoro Drive Partners** existed as a partnership, the purported partnership was formed and availed of solely for purposes of tax avoidance by artificially overstating basis in the partnership interests of its purported partners. The formation of **Tesoro Drive Partners**, the acquisition of any interest in the purported partnership by the purported partner, the purchase of offsetting options, the transfer of offsetting options to a partnership in return for a partnership interest, the purchase of assets by the partnership, and the distribution of those assets to **Tesoro Drive Investors Inc.** in complete liquidation of the partnership interests, and the subsequent sale of those assets to generate a loss, all within a period of less than 2 Months, had no business purpose other than tax avoidance, lacked economic substance, and, in fact and substance, constitutes an economic sham for federal income tax purposes. Accordingly, the partnership and the transactions described above shall be disregarded in full **and any purported losses resulting from these transactions are not allowable as deductions** for federal income tax purposes.

3. It is determined that **Tesoro Drive Partners** was a sham, lacked economic substance and, under § 1.701-2 of the Income Tax Regulations, was formed and availed of in connection with a transaction or transactions in taxable year **November 18 to December 27, 1999**, a principal purpose of which was to reduce substantially the present value of its partners' aggregate federal tax liability in a manner that is inconsistent with the intent of Subchapter K of the Internal Revenue Code. It is consequently determined that:

   a. **Tesoro Drive Partners** is disregarded and that all transactions engaged in by the purported partnership are treated as engaged in directly by its purported partners. This includes the determination that the assets purportedly acquired by **Tesoro Drive Partners**, including but not limited to foreign currency options, were acquired directly by the purported partners.

   b. the foreign currency option(s), purportedly contributed to or assumed by **Tesoro Drive Partners**, are treated as never having been contributed to or assumed by said partnership and any gains or losses purportedly realized by **Tesoro Drive Partners** on the option(s) are treated as having been realized by its partners.

   c. the purported partners of **Tesoro Drive Partners** should be treated as not being partners in **Tesoro Drive Partners**.

d. contributions to **Tesoro Drive Partners** will be adjusted to reflect clearly the partnership's or purported partners' income.

4. It is determined that the obligations under the short positions (written call options) transferred to **Tesoro Drive Partners** constitute liabilities for purposes of Treasury Regulation § 1.752-6T, the assumption of which by **Tesoro Drive Partners** shall reduce the purported partners' bases **for GW Tesoro Inv. LLC, Gary Woods, single member and BJM Tesoro Drive Inv. LLC and Billy J. McCombs, single member** in **Tesoro Drive Partners** in the amounts of **$7,600,000 and $4,750,000** respectively but not below the fair market value of the purported partnership interest.

5. It is determined that neither **Tesoro Drive Partners** nor its purported partners entered into the option(s) positions or purchase the foreign currency or stock with a profit motive for purposes of § 165(c)(2).

6. It is determined that, even if the foreign currency option(s) are treated as having been contributed to **Tesoro Drive Partners**, the amount treated as contributed by the partners under section 722 of the Internal Revenue Code is reduced by the amounts received by the contributing partners from the contemporaneous sales of the call option(s) to the same counter-party. Thus, the basis of the contributed option(s) is reduced, both in the hands of the contributing partners and **Tesoro Drive Partners**. Consequently, any corresponding claimed in-

creases in the outside basis in **Tesoro Drive Partners** resulting from the contributions of the foreign currency option(s) are disallowed.

7. It is determined that the adjusted bases of the long call positions (purchased call options), and other contributions purportedly contributed by the partners to **Tesoro Drive Partners** has not been established under I.R.C. § 723. It is consequently determined that the partners of **Tesoro Drive Partners** have not established adjusted bases in their respective partnership interests in an amount greater than zero (-0-).

8. It is further determined that, in the case of a sale, exchange, or liquidation of **Tesoro Drive Partners** partners' partnership interests, neither the purported partnership nor its purported partners have established that the bases of the partners' partnership interests were greater than zero for purposes of determining gain or loss to such partners from the sale, exchange, or liquidation of such partnership interest.

9. Accuracy-Related Penalties

   It is determined that the adjustments of partnership items of **Tesoro Drive Partners** are attributable to a tax shelter for which no substantial authority has been established for the position taken, and for which there was no showing of reasonable belief by the partnership or its partners that the position taken was more likely than not the correct treatment of the tax shelter and related transactions. In addition, all of the underpayments of tax result-

ing from those adjustments of partnership items are attributable to, at a minimum, (1) substantial understatements of income tax, (2) gross valuation misstatement(s), or (3) negligence or disregarded rules or regulations. There has not been a showing by the partnership or any of its partners that there was reasonable cause for any of the resulting underpayments, that the partnership or any of its partners acted in good faith, or that any other exceptions to the penalty apply. It is therefore determined that, at a minimum, the accuracy-related penalty under Section 6662(a) of the Internal Revenue Code applies to all underpayments of tax attributable to adjustments of partnership items of **Tesoro Drive Partners**. The penalty shall be imposed on the components of underpayment as follows:

A. a 40 percent penalty shall be imposed on the portion of any underpayment attributable to the gross valuation misstatement as provided by Sections 6662(a), 6662(b)(3), 6662(e), and 6662(h) of the Internal Revenue Code.

B. a 20 percent penalty shall be imposed on the portion of the underpayment attributable to negligence or disregard of rules and regulations as provided by Sections 6662(a), 6662(b)(1), 6662(c) of the Internal Revenue Code.

C. a 20 percent penalty shall be imposed on the underpayment attributable to the substantial understatement of income tax as provided by

sections 6662(a), 6662(b)(2), and 6662(d) of the Internal Revenue Code.

D. a 20 percent penalty shall be imposed on the underpayment attributable to the substantial valuation misstatement as provided by Sections 6662(a), 6662(b)(3), and 6662(e) of the Internal Revenue Code.

It should not be inferred by the determination of the Accuracy Related Penalty in this notice that fraud penalties will not be sought on any portion of an underpayment subsequently determined to be attributable to fraud or that prosecution for criminal offenses will not be sought under IRC § 7201, 7206 or other provisions of federal law if determined to be appropriate.

MEADOWS, OWENS, COLLIER, REED, COUSINS & BLAU, L.L.P.
ATTORNEYS AT LAW
A REGISTERED LIMITED LIABILITY PARTNERSHIP INCLUDING PROFESSIONAL CORPORATIONS
901 MAIN STREET, SUITE 3700
DALLAS, TEXAS 75202
(214) 744-3700
www.meadowsowens.com

DAVID E. COLMENERO
Associate

FAX (214) 747-3732
WATS (800) 451-0093
dcolmenero@meadowsowens.com

Feb. 2, 2005

VIA FEDERAL EXPRESS

Stella Pullin, Operations Manager
Internal Revenue Service
3651 S. Interregional Hwy.
Austin, Tx 78741

Re: Cash Deposit under IRC Section 6603 and 6226(e) Gary Woods and Glenda M. Woods: SSN: [REDACTED]

Dear Ms. Pullin:

Enclosed as a cash deposit made pursuant to Section 6226(e) and Section 6603 of the Internal Revenue Code, is a check in the amount of $906,934.00 The check is numbered 2170 and is drawn on Frost National Bank. This amount is deposited with respect to income tax for the above taxpayers' period December 31,

1999 with $762,810.00 representing tax and $144,124.00 representing interest. This payment is remitted in satisfaction of the jurisdictional deposit required under Section 6226(e) of the Internal Revenue Code.

Solely for the purposes of complying with Section 6603, the taxpayers reasonably estimate that, out of the deposited amount, the maximum amount of any tax attributable to disputable items for the period ended December 31, 1999 is $762,810.00. The remaining amount represents interest. The taxpayers do not concede liability, and nothing contained herein should be construed as a concession of any tax, penalty or interest liability.

Please date-stamp the copy of the attached check and sign a copy of this letter and return it to me in the enclosed self-addressed, stamped envelope.

Yours very truly,

/s/ DAVID E. COLMENERO
DAVID E. COLMENERO

DEC: 314331
Enclosures

cc: Joel N. Crouch (*of the Firm*)
Gary Woods

ACKOWLEDGED AND RECEIVED:

By: _____

Printed

Name: _____

Date: _____

Internal Revenue Service

UNITED STATES DISTRICT COURT
FOR THE WESTERN DISTRICT OF TEXAS
SAN ANTONIO DIVISION

Case No. SA05CA0217XR

GARY WOODS AS TAX MATTERS PARTNER OF SA TESORO INVESTMENT PARTNERS, A TEXAS GENERAL PARTNERSHIP, PLAINTIFFS

v.

UNITED STATES OF AMERICA, DEFENDANT

PETITION FOR READJUSTMENT OF PARTNERSHIP ITEMS UNDER CODE SECTION 6226

Petitioners SA Tesoro Investment Partners, a Texas general partnership, and Gary Woods as Tax Matters Partner (collectively "Petitioners") file this Petition for Readjustment of Partnership Items Under 26 U.S.C. § 6226 (the "Petition") against Defendant, The United States of America. In support of this Petition, Petitioners will show the Court as follows:

I. PETITIONERS

1. **Petitioner SA Tesoro Investment Partners ("SATI Partners" or the "Partnership")** is a Texas general partnership. Its principal place of business is at 755 East Mulberry, Suite 600, San Antonio, Texas 78212 and its federal employer identification number is 74-2936192.

2. For the tax year ending December 27, 1999, the Partnership filed its return with the Austin, Texas office of the Internal Revenue Service.

3. **GW Tesoro Investments LLC ("GW")** is a limited liability company formed under Delaware law that is wholly owned and operated by **Gary Woods ("Woods")** and is disregarded for federal income tax purposes. GW is a 10% partner in SATI Partners for tax year ending December 27, 1999.

4. GW is now a dissolved entity. For this reason, Gary Woods, as sole member of GW, files this petition directly rather than through GW.

5. GW's address and principal place of business is 755 East Mulberry, Suite 600, San Antonio, Texas 7821, and its federal employer identification number is 74-2936194.

6. For the 1999 federal income tax year, Woods filed a joint return with his wife, Glenda M. Woods.

7. BJM Tesoro Drive Investments LLC ("BJM") is a limited liability company formed under Delaware law that is wholly owned by Billy J. McCombs ("McCombs") and is disregarded for federal income tax purposes. BJM is a 90% partner in SATI Partners for tax year ending December 27, 1999.

8. BJM is now a dissolved entity.

9. BJM's address and principal place of business is 755 East Mulberry, Suite 600, San Antonio, Texas 7821, and its federal employer identifcation number is 74-2936195.

10. For the 1999 federal income tax year, McCombs filed a joint return with his wife, Charline H. McCombs.

11. Both GW and BJM are single member limited liability companies that, pursuant to Treas. Reg. § 301.7701-(2)(c) are disregarded for federal tax purposes.

12. Woods and McCombs are collectively referred to as the **"Taxpayers"** in this Petition. GW and BJM are collectively referred to as the **"Partners"** or the **"Limited Liability Companies"** in this petition.

13. On December 27, 2004, the Commissioner of Internal Refenue (the "Commissioner") issued a Notice of Final Partnership Administrative Adjustment ("FPAA") against SATI Partners for tax year ending December 31, 1999. The Commissioner issued the FPAA from the Internal Revenue Service ("IRS") office at 316 N. Robert St., St. Paul, MN 55101. A copy of the FPAA is attached to this Petition as Exhibit "A."

14. The proposed adjustments in the FPAA would result in deficiencies for each of the Taxpayers because each Taxpayer, through his respective limited liability company, is a partner in SATI Partners.

15. Petitioner are filing this Petition within ninety days after the day on which the FPAA was mailed to the tax matters partner, GW.

16. On March 17, 2005, SATI and McCombs, as sole owner of BJM, filed a statement with the Internal Revenue Service designating Woods as tax matters partner of

SATI for tax year ending December 29, 1999. A copy of that statement is attached as Exhibit "B".

17. According to Section 6226(a) of the Internal Revenue Code (the "Code"), Petitioners have standing to bring this Petition.

II. DEFENDANT

18. Respondent is The United States of America and will be served by mailing a copy of this Petition and Summons by certified mail, return receipt requested, to (i) Johnny K. Sutton, United States Attorney for the Western District of Texas, 601 N.W. Loop 410, Ste. 600, San Antonio, TX 78216, (ii) the Honorable John Ashcroft, Attorney General of the United States, United States Department of Justice, 950 Pennsylvania Ave., N.W., Room B-324, Washington DC 20530; (iii) Tim Faulk, Revenue Agent, 316 N. Roberts Street, St. Paul Minnesota 55101; (iv) Patrick Kelly, Group Manager, Internal Revenue Service, Small Business/Self Employed Business Division, Area 9, 21 S.W. Second Street, Rm. 301, Rochester, Minnesota 55902; (v) Bert Snider, Territory Manager, 316 N. Roberts Street, St. Paul, Minnesota 55101; (vi) Kevin Harris, Territory Manager, Small Business/Self Employed Business Division, Area 9, 1222 Spruce Street, Saint Louis, Missouri 64103; and (vii) Farris R. Fink, Area 9 Director, Internal Revenue Service, Small Business/Self Employed Business Division, 316 North Robert Street, St. Paul Minnesota 55101.

III. STATEMENT OF CASE

19. This is a civil action arising under Section 6226(a) of the Code for the redetermination of final partnership

administrative adjustments to SATI Partners' Form 1065 income tax return for the tax year ended December 31, 1999, as set forth by the Commissioner in the FPAA.

20. For the tax year ended December 31, 1999, the Commissioner erroneously and illegally determined that: (a) the form of the transactions at issue should be re-characterized or disregarded under a number of different theories; (b) SATI Partners should be disregarded as a partnership for federal income tax purposes; and (c) several corresponding adjustments should be made to Petitioners' tax liabilities.

IV. JURISDICTION AND VENUE

21. Code Sections 6226(a) and 28 U.S.C. § 1346(a)(1) confer jurisdiction on this Court.

22. For jurisdiction purposes, Petitioners have complied with the requirements of Code Section 6226(e) by having Woods, as the tax matters partner and sole owner, of GW, deposit the amount by which his federal income tax liability would be increased if treatment of the Partnership items on his tax returns for the tax years at issue were made consistent with the treatment of partnership items on SATI Partners' tax returns as adjusted by the Commissioner in the FPAA. Petitioners have also included interest in their deposit. These amounts are referred to herein as the Deposit.

23. The Deposit is in the amount of $906,934 and was remitted to the Internal Revenue Service in Austin, Texas on Febrary 2, 2005.

24. A true and correct copy of the letter and the check sent to the IRS representing the above Deposit are attached to this Petition as Exhibit "B."

25. Venue is proper in the Western District of Texas, San Antonio Division, according to Section 6226(a) and 28 U.S.C. § 1402.

V. DESCRIPTION OF TRANSACTIONS

26. After consulation with and obtaining the advice, guidance, and counsel of qualified tax professionals, the Taxpayers entered into the following transactions (the "Transactions").

Purchase of Long and Sale of Short Options

27. On November 18, 1999, the Taxpayers, through their wholly-owned limited liability companies (collectively, the "Limited Liability Companies"), entered into certain over-the-counter, non-publicly traded European-style foreign currency option positions on the Japanese Yen, Swiss Franc, and Australian Dollar (collectively the "Options") with Deutsche Bank of AG New York Branch (the "Bank").

28. Each Taxpayer purchased a Long Option and sold a Short Option.

Details of Long Options

29. Woods bought a digital option on the Japanese Yen/U.S. Dollar exchange rate at a strike price of 103.87 Japanese Yen per U.S. $1.0 with an expiration date of December 20, 1999, a settlement date of December 22, 1999, and a payoff amount of $6,600,000 and paid a premium of $3,300,000.

30. McCombs bought a digital option on the Swiss Franc/U.S. Dollar exchange rate at a strike price of 1.5626 Swiss Francs per U.S. $1.0 with an expiration date of December 20, 1999, a settlement date of December 22, 1999, and a payoff amount of $25,000,000 and paid a premium of $12,500,000.

31. McCombs also bought a digital option on the U.S. Dollar/Australian Dollar exchange rate at a strike price of $0.6502 U.S. Dollars per 1.0 Australian Dollar, with an expiration date of December 20, 1999, a settlement date of December 22, 1999 and a payoff of $34,400,000 and paid a premium of $17,200,000.

32. The options described in paragraphs 29 through 31 are referred to as the "Long Options."

Details of Short Options

33. Woods sold a digital option on the Japanese Yen/U.S. Dollar exchange rate at a strike price of 103.85 Japanese Yen per U.S. $1.0 and received a premium of $3,135,000 with an expiration date of December 20, 1999, a settlement date of December 22, 1999, and a payoff amount of $6,187,500.

34. McCombs sold a digital option on the Swiss Franc/U.S. Dollar exchange rate at a strike price of 1.5628 Swiss Francs per U.S. $1.0 and received a premium of $11,875,000 with an expiration date of December 20, 1999, a settlement date of December 22, 1999, and a payoff amount of $23,437,500.

35. McCombs also sold a digital option on the U.S. Dollar/Australian Dollar exchange rate at a strike price

of $0.6504 U.S. Dollars per 1.0 Australian Dollar and received a premium of $16,340,000 with an expiration date of December 20, 1999, a settlement date of December 22, 1999 and a pay off amount of $32,250,000.

36. The options described in paragraphs 33 through 35 are referred to as the "Short Options." Together the Long Options and the Short Options are referred to as the "Options."

Contribution of the Options to SATI Partners

37. On November 19, 1999, the Taxpayer contributed the Options to SATI Partners as contributions to capital.

Options Terminate

38. On December 17, 1999 SATI Partners' option positions terminated. The date of termination was established after careful monitoring of the applicable exchange rates in order to maximize the overall return on investment.

Purchase of Shares

39. On December 13, 1999, SATI Partners purchased Shares of Sun Microsystems, Inc. (the "Shares") as an investment.

Contribution of Partnership Interests to SATI, Inc.

40. On December 27, 1999, Woods contributed his interest in SATI Partners to SA Tesoro Investors, Inc. ("SATI, Inc."), a Delaware corporation, in which he held a 10% shareholder interest.

41. On December 27, 1999, McCombs contributed his interest in SATI Partners to SATI, Inc. in which he was a 90% shareholder.

SATI, Inc.'s Sale of the Investments in Shares

42. On December 27, 1999, SATI Partners was dissolved and liquidated because each Taxpayer contributed his interest in SATI Partners to SATI, Inc. Upon liquidation, all of the Shares were distributed to SATI, Inc.

43. SATI, Inc. sold all of its investments in the Shares on December 29, 1999.

44. SATI, Inc.'s sale of its investment in the Shares triggered a loss that was reported on SATI, Inc.'s 1120S and the corresponding Schedule K-1s for the 1999 tax year. The aggregate loss was in the amount of $32,297,786.

VI. 1999 TAX RETURNS

45. SATI Partners timely filed its Form 1065 for the short tax year ending December 27, 1999, the date of SATI partners' dissolution. Ernst & Young LLP prepared SATI Partners' tax return.

46. SATI, Inc. timely filed a Form 1120S for the tax year ending December 31, 1999. Ernst & Young LLP prepared SATI, Inc.'s tax return.

47. As required under applicable federal tax law, the Taxpayers timely filed their respective federal income tax returns for the 1999 tax year, which included their respective share of income, losses, and deductions from

SATI, Inc. and SATI Partners as reflected in the returns previously prepared by Ernst & Young LLP.

48. The loss generated by SATI, Inc.'s sale of the Shares was allocated to the limited liability companies owned by the Taxpayers on their respective K-1s for the 1999 tax year as follows: (a) $3,229,779 was allocated to Woods; and (b) $29,068,007 was allocated to McCombs.

VII. RELIANCE ON TAX PROFESSIONALS

49. Petitioners sought the advice, counsel, and guidance of competent tax professionals, including but not limited to, professionals at Jenkens & Gilchrist P.C., Brown & Wood LLP, and Ernst & Young LLP in determining the federal income tax consequences and proper reporting obligations relative to the Transactions described in Section V above before filing their respective federal income tax returns.

50. The Taxpayers have utilized the services of Ernst & Young LLP since at least the mid to late Eighties in connection with accounting, audit, tax and investment matters. Over the years, the Taxpayers, as businessmen, venture capitalists and entrepreneurs, have established a strong business and personal relationship with various individuals at Ernst & Young LLP.

51. The Taxpayers were introduced to the Transactions by representatives of Ernst & Young LLP with whom the Taxpayers had a long-standing personal and business relationship. These representatives presented the Transactions as sound and legal business investments, both before and after tax considerations were taken into account.

52. Ernst & Young LLP ultimately provided advice regarding all aspects of the Transactions, including profit potential, investment strategy, choice of entities, business structure, accounting and tax reporting.

53. Based on the information and guidance provided by professionals at Ernst & Young, the Taxpayers at all times regarded the Transactions as investments carrying the potential for generating significant profits, independent of any tax benefits.

54. As with all other advice and services provided by Ernst & Young over the years, the Taxpayers have at all times considered Ernst & Young LLP to be a qualified and independent professional entity having no interest in the Transactions other than in the capacity of providing professional investment, accounting and tax advice.

55. At the suggestion of Ernst & Young, the Taxpayers each obtained a separate written legal opinion from Jenkens & Gilchrist P.C. dated January 31, 2000 (collectively, the "Jenkens Opinions"). In the Jenkens Opinions, Jenkens & Gilchrist P.C. provided an opinion on a more likely than not basis regarding the federal tax consequences of the Transactions as ratified by the other opinions received and the positions taken on the federal tax returns by Ernst & Young LLP. The conclusions set forth in the Jenkens Opinions provided the bases for the manner in which the Transactions were reported for federal tax purposes.

56. The Jenkens Opinions were provided to the Taxpayers before they filed their federal income tax returns for the 1999 tax year.

57. The Jenkens Opinions conclude it is more likely than not that:

(a) Each of the Limited Liability Companies, as a single member limited liability company, should be disregarded as an entity for federal income tax purposes;

(b) Investing in the Options should not be taxable, and the Options should be treated as separate instruments for federal income tax purposes;

(c) SATI Partners should be classified as a partnership for federal income tax purposes;

(d) The Taxpayers' contributions of their respective Options to SATI Partners should not result in a taxable gain or loss;

(e) The Short Options should not be liabilities within the meaning of Code Section 752 as amended;

(f) Each of the Partners' basis in SATI Partners after contribution of their respective Options should include the cost of the Long Option contributed, without adjustment for the Short Option;

(g) An adjustment to each of the Partners' adjusted basis in their respective partnership interests should be required as a result of the expiration of the Option, due to the recognition of ordinary income on such expiration under Code Section 1234;

(h) Contribution by each of the Partners of their respective interest in SATI Partners to SATI, Inc. should not be a taxable transaction, and SATI, Inc.'s basis in the partnership interest contributed by the Partners should

be equal to their basis in such interests as of the date of such contribution;

(i) Each of the Partners' basis in their interest in SATI, Inc. should be increased by an amount equal to the adjusted basis of their interest in SATI Partners as of the date of contribution;

(j) The liquidation of SATI Partners should not result in gain or loss recognition;

(k) The liquidation of SATI Partners should result in an allocation of SATI Partners' "outside" basis to the properties distributed by it in the liquidation, which consisted of cash and an investment in the Shares in this case;

(l) The disposition by SATI, Inc. of all the Shares received in liquidation of SATI Partners should result in a short-term capital loss;

(m) The step transaction and sham transaction doctrines should not apply to the Transactions;

(n) Code Sections 707(a)(2)(B), 165(c), 465, 469, and 1092 should not apply to the Transactions; and

(o) Treasury Regulation Section 1.701-2 should not apply to the Transactions.

58. Thereafter, the Taxpayers each obtained corroborating written legal opinions from Brown & Wood, LLP (the "BW Opinions"). Collectively the Jenkens Opinions and the BW Opinions are referred to as the "Legal Opinions."

59. Petitioners relied on their various long term tax advisors at Ernst & Young LLP as well as on the Legal Opinions to determine and advise Petitioners regarding the tax consequences of the Transactions. This reliance was reasonable and in good faith.

VIII. COMMISSIONER'S ERRORS IN FPAA

60. Petitioners incorporate paragraphs 1 through 59 as though fully set forth here.

61. The Commissioner erred in determining that:

a) The ordinary income of the Partnership should be decreased by $50,000 for the tax year ending December 31, 1999.

b) The tax exempt interest of the Partnership should be decreased by $958 for tax year ending December 31, 1999.

c) Neither SATI Partners nor its Partners have established the existence of SATI Partners as a partnership as a matter of fact.

d) Even if SATI Partners existed as a partnership, it was formed and availed of solely for purposes of tax avoidance by artificially overstating basis in the partnership interests of its Partners.

e) The formation of SATI Partners, the acquisition of any interest in the partnership by the Partners, the purchase of offsetting options, the transfer of offsetting options to the Partnership in return for a partnership interest, the purchase of assets by the Partnership, and the distribution of those assets to SATI, Inc. in com-

plete liquidation of the partnership interests, and the subsequent sale of those assets to generate a loss, all within a period of less than two months, had no business purpose other than tax avoidance, lacked economic substance, and, in fact and substance, constitutes an economic sham for federal income tax purposes.

f) The Partnership and the Transactions shall be disregarded in full and any purported losses resulting from these Transactions are not allowable as deductions.

g) SATI Partners was a sham, lacked economic substance, and, under Treas. Reg. § 1.701-2, was formed and availed of in connection with a transaction or transactions in taxable year November 12 to December 27, 1999, a principal purpose of which was to reduce substantially the present value of its Partners' aggregate federal tax liability in a manner that is inconsistent with the intent of Subchapter K of the Internal Revenue Code.

h) SATI Partners is disregarded and all transactions engaged in by the Partnership are treated as engaged in directly by its Partners. This includes the determination that the assets purportedly acquired by SATI Partners, including, but not limited to, the Options, were acquired directly by the Partners.

i) The Options contributed to or assumed by SATI Partners, are treated as never having been contributed to or assumed by the Partnership and any gains or losses realized by SATI Partners on the Options are treated as having been realized by its Partners.

j) The Partners of SATI Partners should be treated as not being partners in SATI Partners.

k) Contributions to SATI Partners will be adjusted to reflect clearly the Partnership's or Partners' income.

l) The obligations under the short positions (written call options) transferred to SATI Partners constitute liabilities for purposes of Treas. Reg. § 1.752-6T, the assumption of which by SATI Partners shall reduce the Partners' bases for GW and BJM in SATI Partners in the amount of $3,135,000 and $28,215,000, respectively, but not below the fair market value of the partnership interest.

m) Neither SATI Partners nor its Partners entered into the Options or the investments in Foreign Currency with a profit motive for purposes of Code Section 165(c)(2).

n) Even if the Options are treated as having been contributed to SATI Partners, the amount treated as contributed by the Partners under Code Section 722 is reduced by the amounts received by the contributing Partners from the contemporaneous sales of the call options to the same counter-party.

o) The basis of the Options is reduced, both in the hands of the contributing Partners and SATI Partners. Consequently, any corresponding claimed increases in the outside basis in SATI Partners resulting from the contributions of the Options are disallowed.

p) The adjusted bases of the long call positions (purchased call options) and other contributions made by the Partners to SATI Partners have not been established under Code Section 723.

q) The Partners of SATI Partners have not established adjusted bases in their respective partnership interests in an amount greater than zero (-0-).

r) In the case of a sale, exchange, or liquidation of SATI Partners' partnership interests, neither the Partnership nor its Partners have established that the bases of the Partners' partnership interests were greater than zero for purposes of determining gain or loss to such Partners from the sale, exchange, or liquidation of such partnership interest.

s) The adjustments of partnership items of SATI Partners are attributable to a tax shelter for which no substantial authority has been established for the position taken, and for which there was no showing of reasonable belief by the Partnership or its partners that the position taken was more likely than not the correct treatment of the tax shelter and related transactions.

t) In addition, all of the underpayment of tax resulting from those adjustments of partnership items are attributable to, at a minimum, (1) substantial understatements of income tax, (2) gross valuation misstatement(s), or (3) negligence or disregarded rules or regulations.

u) There has not been a showing by the Partnership or any of its Partners that there was reasonable cause for any of the resulting underpayments, that the Partnership or any of its Partners acted in good faith, or that any other exceptions to the penalty apply.

v) At a minimum, the accuracy-related penalty under Section 6662(a) of the Internal Revenue Code

applies to all underpayment of tax attributable to adjustments of partnership items of the Partnership.

w) A 40 percent penalty under Sections 6662(a), 6662(b)(3), 6662(e), and 6662(h) of the Code should be imposed on the portion of any underpayment attributable to a gross valuation misstatement.

x) A 20 percent penalty under Sections 6662(a), 6662(b)(1) and 6662(c) of the Code should be imposed on the portion of any underpayment attributable to negligence or disregard of rules and regulations.

y) A 20 percent penalty under Sections 6662(a), 6662(b)(2), and 6662(d) of the Code should be imposed on the portion of any underpayment attributable to a substantial understatement of income tax.

z) A penalty of 20 percent under Sections 6662(a), 6662(b)(3), and 6662(e) of the Code should be imposed on the portion of any underpayment attributable to a substantial valuation misstatement.

62. The Commissioner erred in making each and every adjustment in the FPAA.

IX. VALIDITY OF FINAL PARTNERSHIP ADMINISTRATIVE ADJUSTMENT

63. Petitioners incorporate paragraphs 1 through 62 as though fully set forth here.

64. The FPAA is invalid because it relates to a tax year that does not exist. SATI Partners dissolved as of December 27, 1999 and does not have a tax year ending December 31, 1999.

X. TD PARTNERS CORRECT TREATMENT OF TAX ITEMS

65. Petitioners incorporate paragraphs 1 through 64 as though fully set forth herein.

66. Petitioners properly determined all items of income, losses, deductions, and credits of SATI Partners for the tax year ending December 27, 1999.

67. Petitioners properly calculated and reported the tax exempt interest of SATI Partners in the amount of $958 for tax year ending December 27, 1999.

68. Petitioners properly calculated and reported ordinary income of SATI Partners in the amount of $50,000 for tax year ending December, 1999.

69. Taxpayers properly determined the Partners' outside basis in SATI Partners for tax year ending December 27, 1999.

70. SATI Partners is a partnership validly created, existing, and recognized for all state and federal law purposes, including federal income tax purposes for tax year ending December 27, 1999.

71. SATI Partners was not a sham for federal income tax purposes for tax year ending December 27, 1999.

72. SATI Partners did not lack economic substance for federal income tax purposes for tax year ending December 27, 1999.

73. No part of the Partnership or the Transactions may be ignored, disregarded or recharacterized on the basis that they lacked business purpose, economic sub-

stance or otherwise constituted a sham for federal income tax purposes.

74. The losses and other benefits claimed by the Petitioners on their federal tax returns cannot be disallowed on the basis that either the Transactions or any of the entities involved constituted shams or lacked economic substance or business purpose because none of these doctrines are incorporated into or otherwise a part of the Code.

75. Disallowance of the losses or other benefits claimed by the Petitioners in this case on the basis of either the sham transaction, business purpose or economic substance theories asserted by the Commissioner would violate the separation of powers provisions of the United States Constitution.

76. SATI Partners was not formed or availed of in connection with a transaction or transactions in a manner inconsistent with the intent of Subchapter K of the Code and may not otherwise be disregarded, nor may any of its transactions be recharacterized, in whole or in part, under the authority of Treas. Reg. § 1.701-2 for tax year ending December 27, 1999.

77. Treas. Reg. § 1.701-2 is invalid and inapplicable to the facts of this case.

78. The obligations under the Short Options sold do not constitute liabilities under Code Section 752. Consequently, SATI Partners' assumption of those obligations is not regarded as a distribution of money to the Partners under the Code for tax year ending December 27, 1999.

79. Even if the Options do constitute liabilities under Code Section 752 and the applicable regulations, the amount of the "liability" transferred the Partnership under the Options is $0. As such, the Partners' bases in the Partnership cannot be reduced by any part of the Options transferred to the Partnership.

80. The amounts treated as contributed by the Partners under Section 722 of the Internal Revenue Code are not reduced by the amounts received by the Partners from the sale of the Short Options.

81. Temporary Treas. Reg. 1.752-6T is invalid and inapplicable to the facts of this case.

82. Code Section 165(c)(2) does not operate to disallow the losses or other tax benefits claimed by the Partners in this case for tax year ending December 27, 1999.

83. Petitioners properly determined and reported the basis of the Shares transferred from SATI Partners to SATI, Inc. for tax year ending December 27, 1999.

84. In every other respect, the federal tax consequences of the transactions at issue in this case are as set forth in the Legal Opinions discussed above and as reported by Petitioners and Taxpayers on their federal tax returns.

85. Petitioners are not subject to penalties under Code Section 6662 because any tax liability ultimately determined by this Court against them is not attributable to: (a) negligence or disregard or rules or regulations; (b) any substantial understatement of income tax; or

(c) any substantial or gross valuation misstatement under Chapter 1.

86. Petitioners are not subject to penalties under Code Section 6662 because any understatement ultimately determined by the Court is attributable to items for which the relevant facts were adequately disclosed in Petitioners' returns or in a statement attached to the returns; and there is a reasonable basis for the tax treatment of such item by the taxpayer.

87. The Transactions at issue in this case do not constitute a tax shelter.

88. In the alternative, even if the Transactions do constitute a tax shelter, Petitioners are not subject to penalties under Code Section 6662 because any understatement ultimately determined by the Court is, based on the foregoing, attributable to the tax treatment of items for which there is or was substantial authority for such treatment, and, furthermore, Petitioners reasonably believed that the tax treatment of such item by Petitioners was more likely than not the proper treatment.

89. Petitioners are not subject to penalties under Code Section 6662(b)(1) because they were not negligent nor did they disregard any rules or regulations as contemplated by Code Section 6662.

90. Petitioners are not subject to penalties under Code Section 6662(b)(2) because there is no substantial understatement of income tax as contemplated by Section 6662.

91. Petitioners are not subject to penalties under Code Section 6662(b)(3) because there is no substantial or gross valuation misstatement as contemplated by Code Section 6662.

92. Petitioners are not subject to penalties under Code Section 6662 on any underpayment ultimately determined because there was, based on the foregoing, reasonable cause for such underpayment and Petitioners acted in good faith as contemplated by Code Section 6664(c)(1).

93. Petitioners relied on the advice provided by tax professionals including, but not limited to, Jenkens & Gilchrist, P.C., Brown & Wood, LLP and Ernst & Young, LLP. In addition, the reliance on such advice was reasonable and in good faith. Thus, under the authority of Code Section 6664(c)(1) and Treasury Regulation § 1.6664-4, Petitioners are not subject to the penalties imposed by the IRS under Code Section 6662.

XI. PRAYER

Petitioners respectfully pray for judgment against Defendant and respectfully ask the Court to declare the FPAA invalid or alternatively to order Defendant to reverse the adjustments set forth in the FPAA. Petitioners further pray that the Court order Defendant to return the Deposit plus interest to Woods. Petitioners also request that the Court grant them such further relief, legal or equitable, to which they may be entitled.

Respectfully submitted,

By: /s/ JOEL N CROUCH
JOEL N. CROUCH
Texas State Bar No. 05144220
M. Todd Welty
Texas State Bar No. 00788642

MEADOWS, OWENS, COLLIER, REED
COUSINS & BLAU, L.L.P
901 Main Street, Suite 3700
Dallas, TX 75202
(214) 744-3700 Telephone
(214) 747-3732 Facsimile
twelty@meadowsowens.com
jcrouch@meadowsowens.com

ATTORNEYS-IN-CHARGE FOR
PETITIONERS

[Notice 2000-44 Case]

Internal Revenue Service

316 North Robert Street
St. Paul, Minnesota 55101

Date: [Dec. 27, 2004]

Tax Matters Partner
SA Tesoro Investment Partners
755 East Mulberry, Suite 600
San Antonio, TX. 78212

Department of the Treasury

Refer to:
ESB Stop 4020BK

Taxpayer Identifying Number:
74-2936192

Name of Partnership:
SA Tesoro Investment Partners

Partnership Identifying Number:
74-2936192

Tax Year Ended:
December 31, 1999

Date FPAA Mailed to Tax Matters Partner: [Dec. 27, 2004]

Person to Contact:
Bill Kahnke 41-03606

Contact Hours:
8:00 am to 4:30 pm

Contact Telephone Number:
(651) 312-7909

NOTICE OF FINAL PARTNERSHIP ADMINISTRATIVE ADJUSTMENT

The law requires us to send a Notice of Final Partnership Administrative Adjustment (FPAA) to the partnership named above, for the tax year shown above, and to each partner who is entitled to receive this notice.

We are proposing adjustments to the partnership items of the partnership and tax year shown above. We will send the examination report outlining these adjustments to the Tax Matters Partner (TMP) of the partnership. (The TMP is the partner designated by the partnership to deal with the IRS.) He/she is also authorized to act for the partners who are not entitled to receive this notice. Any partner who wants a copy of the examination report should request it from the TMP. If the TMP is unable to provide you with a copy of the examination report, please contact the person named in the heading of this letter.

Taxable Years Ending Before August 6, 1997:

The adjustments to the partnership items reported on the partnership tax return may cause an increase or decrease to the tax liability on your individual return. Form 870-P, *Agreement to Assessment and Collection of Deficiency in Tax for Partnership Adjustments*, is a summary of the proposed adjustments to the partnership return. You can compute your share of the proposed adjustments by multiplying each adjusted partnership item by your percentage interest for that partnership item

Taxable Years Ending After August 5, 1997:

The adjustments to the partnership items reported on the partnership tax return may cause an increase or decrease in the tax liability on your individual return. The adjustments may include partnership level determinations regarding penalties and additions to tax that relate to adjustments to partnership items. Form 870-PT, *Agreement for Partnership Items and Partnership Level Determinations as to Penalties, Additions to Tax, and Additional Amounts*, is a summary of the proposed adjustments to the partnership return. You can compute your share of the proposed adjustments by multiplying each adjusted partnership item by your percentage interest for that partnership item.

You have three options available to you:

1. **If you agree with the adjustments:**

Sign and return the enclosed Form 870-P/Form 870-PT. When you sign Form 870-P/Form 870-PT, you are agreeing to pay any additional tax and interest resulting from the adjustments to the partnership return. For tax years ending after August 5, 1997, you are also agreeing to any partnership level determinations as to penalties, additions to tax and additional amounts that relate to adjustments to partnership items, if any. In addition, you are waiving your rights to participate in any administrative or judicial proceeding affecting partnership items and in partnership level determinations as to penalties, additions to tax and additional amounts that relate to adjustments to partnership items for the tax year in question. This is a binding settlement only if

you sign and return Form 870-P/Form 870-PT and we sign on behalf of the Commissioner of the Internal Revenue Service. When we sign the agreement form, the one-year extension of the period of limitations on assessments will begin under Internal Revenue Code section 6229(f). Once the agreement is signed by both parties, you may not file a claim to change the items in quesiton or claim a refund/credit based on a readjustment.

Note: If you are the TMP of the partnership, see the section of this letter entitled, "*For the Tax Matters Partner of the Partnership*".

2. If you do not agree with the adjustments:

If you are the TMP of the partnership and want to contest the adjustments in the court, you must file a petition within 90 days from the date of this letter. During this 90-day period, no other partner may file a petition for judicial review. You can file your petition for readjustment of partnership items with:

4. the United States Tax Court;
5. the United States Court of Federal Claims; or
6. the District Court of the United States, in the district of the partnership's principal place of business.

A petition filed by the TMP precludes all other actions. If the TMP doesn't file a petition by the 90th day from the date the FPAA was mailed, any partner or any 5 percent group entitled to receive this notice may petition one of these courts. A "5 percent group" includes

any group of partners who together have an interest of five percent or more in profits of the partnership. The petition must be filed after the 90th day, but on or before the 150th day from the date the FPAA was mailed to the TMP. If more than one petition is filed in Tax Court, the first petition filed will go forward. All other petitions (even those filed earlier in one of the other courts) will be dismissed. If no one else files a petition in Tax Court, the first petition filed in one of the other courts will go forward and subsequent petitions will be dismissed.

Petitions filed with the United States Tax Court must be mailed to:

United States Tax Court
400 Second Street, NW
Washington, DC 20217

Attach a copy of this letter to the petition. The time in which you must file a petition with the court is fixed by law and the court cannot consider your case if your petition is filed late. If this letter is addressed to both a husband and wife and both want to petition the Tax Court, both must sign the petition or each must file a separate signed petition.

When a partner (including each member of a 5 percent group that files a petition) files a petition in either the appropriate District Court or the Court of Federal Claims, the partner filing the petition must deposit the amount that the partner's tax liability would be increased if the treatment of the partnership items on the partner's return were made consistent with the treatment of part-

nership items under the FPAA. If you reported the partnership items the way the partnership reported them on its return, you can generally determine the amount to deposit by taking your pro rata share of the partnership adjustments into account in recomputing your tax. You must deposit the appropriate amount with the IRS on or before the day you file your petition.

3. **If you do nothing:**

If a petition for readjustment is not filed in any of the courts listed in this letter, the FPAA becomes final, and we will bill you for any additional tax plus interest that you may owe under the FPAA. You will not be permitted to contest the treatment of the partnership items of the partnership under the FPAA in any refund claim or suit. The law allows the Service to bill you after 150 days from the mailing date of the FPAA to the TMP.

However, if a petition is filed in the Tax Court, and the Tax Court upholds the adjustments in whole or in part, we will not bill you until the Tax Court decision is final.

You may wish to contact the TMP of the partnership or your tax advisor to discuss this matter.

If you have any questions, please write to the person whose name and address are shown in the heading of this letter. If you write, attach a copy of this letter to help identify your account. Also, include your telephone number and the most convenient time for us to call you in case we need additional information.

If you prefer, you may call the IRS contact person at the telephone number shown in the heading of this letter. If this number is outside your local calling area, there will be a long distance charge to you.

Thank you for your cooperation.

Sincerely,

/s/ KEVIN HARRIS
Kevin Harris [BK]
Technical Services Territory Manager,
Midwest Area

Enclosures:
Form 870-P/Form 870-PT
Copy of this letter

FOR THE TAX MATTERS PARTNER OF THE PARTNERSHIP

If you are the Tax Matters Partner (TMP), you are entitled to make an agreement to bind non-notice partners to the treatment of the partnership items as shown on the enclosed schedule of adjustments. You must add the following statement above the signature blocks on the Form 870-P or Form 870-PT:

"The undersigned Tax Matters Partner is signing this offer on behalf of himself (herself) and all other partners whom he (she) has the authority to bind; a final agreement resulting from the co-signature of the Commissioner of Internal Revenue will be binding on all such other partners."

As the TMP, you may submit a petition, as described above for the partnership on behalf of all partners.

If you have any questions, you can call the IRS contact person at the telephone number shown in the heading of this letter. Thank you for your cooperation.

Internal Revenue Service

316 North Robert Street
St. Paul, Minnesota 55101

Date: [Dec. 27, 2004]

Tax Matters Partner
SA Tesoro Investment Partners
755 East Mulberry, Suite 600
San Antonio, TX 78212
Department of the Treasury

Refer To:
ESB Stop 4020BK

Taxpayer Identifying Number:
74-2936192

Name of Partnership:
SA Tesoro Investment Partners

Partnership Identifying Number:
74-2936192

Tax Year Ended:
December 31, 1999

Date FPAA Mailed to Tax Matters Partner:
[Dec. 27, 2004]

Person to Contact:
Bill Kahnke
41-03606

Contact Hours:
8:00 am to 4:30 pm

Contact Telephone Number:
(651) 312-7909

NOTICE OF FINAL PARTNERSHIP ADMINSTRATIVE ADJUSTMENT

The law requires us to send a Notice of Final Partnership Administrative Adjustment (FPAA) to the partnership named above, for the tax year shown above, and to each partner who is entitled to receive this notice.

We are proposing adjustments to the partnership items of the partnership and tax year shown above. We will send the examination report outlining these adjustments to the Tax Matters Partner (TMP) of the partnership. (The TMP is the partner designated by the partnership to deal with the IRS.) He/she is also authorized to act for the partners who are not entitled to receive this notice. Any partner who wants a copy of the examination report should request it from the TMP. If the TMP is unable to provide you with a copy of the examination report, please contact the person named in the heading of this letter.

Taxable Years Ending Before August 6, 1997:

The adjustments to the partnership items reported on the partnership tax return may cause an increase or decrease to the tax liability on your individual return. Form 870-P, *Agreement to Assessment and Collection of Deficiency in Tax for Partnership Adjustments*, is a summary of the proposed adjustments to the partnership return. You can compute your share of the proposed adjustments by multiplying each adjusted partnership

item by your percentage interest for that partnership item.

Taxable Years Ending After August 5, 1997:

The adjustments to the partnership items reported on the partnership tax return may cause an increase or decrease in the lax liability on your individual return. The adjustments may include partnership level determinations regarding penalties and additions to tax that relate to adjustments to partnership items. Form 870-PT, *Agreement for Partnership Items and Partnership Level Determinations as to Penalties, Additions to Tax, and Additional Amounts*, is a summary of the proposed adjustments to the partnership return. You can compute your share of the proposed adjustments by multiplying each adjusted partnership item by your percenttage interest for that partnership item.

You have three options available to you:

1. **If you agree with the adjustments:**

Sign and return the enclosed Form 870-P/Form 870-PT. When you sign Form 870-P/Form 870-PT, you are agreeing to pay any additional tax and interest resulting from the adjustments to the partnership return. For tax years ending after August 5, 1997, you are also agreeing to any partnership level determination as to penalties, additions to tax and additional amounts that relate to adjustments to partnership items, if any. In addition, you are waiving your rights to participate in any administrative or judicial proceeding affecting partnership items and in partnership level determinations as to penalties, additions to tax and additional amounts that

relate to adjustments to partnership items for the tax year in question. This is a binding settlement only if you sign and return Form 870-P/Form 870-PT and we sign on behalf of the Commissioner of Internal Revenue Service. When we sign the agreement form, the one-year extension of the period of limitations on assessments will begin under Internal Revenue Code section 6229(f). Once the agreement is signed by both parties, you may not file a claim to change the items in question or claim a refund/ credit based on a readjustment.

Note: If you are the TMP of the partnership, see the section of this letter entitled, "*For the Tax Matters Partner of the Partnership*".

2. If you do not agree with the adjustments:

If you are the TMP of the partnership and want to contest the adjustments in the court, you must file a petition within 90 days from the date of this letter. During this 90-day period, no other partner may file a petition for judicial review. You can file your petition for readjustment of partnership items with:

1. the United States Tax Court;
2. the United States Court of Federal Claims; or
3. the District Court of the United States, in the district of the partnership's principal place of business.

A petition filed by the TMP precludes all other actions. If the TMP doesn't file a petition by the 90th day from the date the FPAA was mailed, any partner or any 5 percent group entitled to receive this notice may peti-

tion one of these courts. A "5 percent group" includes any group of partners who together have an interest of five percent or more in profits of the partnership. The petition must be filed after the 90th day, but on or before the 150th day from the date the FPAA was mailed to the TMP. If more than one petition is filed in the Tax Court, the first petition filed will go forward. All other petitions (even those filed earlier in one of the other courts) will be dismissed. If no one files a petition in Tax Court, the first petition filed in one of the other courts will go forward and subsequent petitions will be dismissed.

Petitions filed with the United States Tax Court must be mailed to:

United States Tax Court
400 Second Street, NW
Washington, DC 20217

Attach a copy of this letter to the petition. The time in which you must file a petition with the court is fixed by law and the court cannot consider your case if your petition is filed late. If this letter is addressed to both a husband and wife and both want to petition the Tax Court, both must sign the petition or each must file a separate signed petition.

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return were made consistent with the treatment of partnership items under the FPAA. If you reported the partnership items the way the partnership reported them on its return, you can generally determine the amount to deposit by taking your pro rata share of the partnership adjustments into account in recomputing your tax. You must deposit the appropriate amount with the IRS on or before the day you file your petition.

3. If you do nothing:

If a petition for readjustment is not filed in any of the courts listed in this letter, the FPAA becomes final, and we will bill you for any additional tax plus interest that you may owe under the FPAA. You will not be permitted to contest the treatment of the partnership items of the partnership under the FPAA in any refund claim or suit. The law allows the Service to bill you after 150 days from the mailing date of the FPAA to the TMP.

However, if a petition is filed in the Tax Court, and the Tax Court upholds the adjustments in whole or in part, we will not bill you until the Tax Court decision is final.

You may wish to contact the TMP of the partnership or your tax advisor to discuss this matter.

If you have any questions, please write to the person whose name and address are shown in the heading of this letter. If you write, attach a copy of this letter to help identify your account. Also, include your telephone number and the most convenient time for us to call you in case we need additional information.

If you prefer, you may call the IRS contact person at the telephone number shown in the heading of this letter. If this number is outside your local calling area, there will be a long distance charge to you.

Thank you for your cooperation.

Sincerely,

/s/ KEVIN HARRIS
KEVIN HARRIS [BK]
Technical Services Territory Manager,
Midwest Area

Enclosures:
Form 870-P/Form 870-PT
Copy of this letter

FOR THE TAX MATTERS PARTNER OF THE PARTNERSHIP

If you are the Tax Matters Partner (TMP), you are entitled to make an agreement to bind non-notice partners to the treatment of the partnership items as shown on the enclosed schedule of adjustments. You must add the following statement above the signature blocks on the Form 870-P or Form 870-PT:

"The undersigned Tax Matters Partner is signing this offer on behalf of himself (herself) and all other partners whom he (she) has the authority to bind; a final agreement resulting from the co-signature of the Commissioner of Internal Revenue will be binding on all such other partners."

As the TMP, you may submit a petition, as described above for the partnership on behalf of all partners.

If you have any questions, you can call the IRS contact person at the telephone number shown in the heading of this letter. Thank you for your cooperation.

Form 870-PT (6-2004)	DEPARTMENT OF THE TREASURY - INTERNAL REVENUE SERVICE **Agreement for Partnership Items and Partnership Level Determinations as to Penalties, Additions to Tax, and Additional Amounts**	IN REPLY REFER TO: ESB Stop 4020

Taxpayer(s) name(s), address and ZIP code:	Name of Partnership:	Tax Year(s) Ended
Tax Matters Partner SA Tesoro Investment Partners 755 East Mulberry, Suite 800 San Antonio, TX 78212 Taxpayer Identifying Number: 74-2936192	SA Tesoro Investment Partners Taxpayer Identifying Number 74-2936192	December 31, 1999
	Name of Tax Matters Partner:	

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Offer of Agreement to Partnership Items and Partnership Level Determinations as to Penalties, Additions to Tax, and Additional Amounts
&
Waiver of Restrictions on Assessment for Partnership Items, Penalties, Additions to Tax, and Additional Amounts

Under sections 6224(c) and 7121 of the Internal Revenue Code (IRC) of 1986, the Commissioner of the Internal Revenue Service and the undersigned taxpayer(s) agree to the determination of partnership items and partnership level determinations as to penalties, additions to tax, and additional amounts that relate to adjustments to partnership items as shown on the attached schedule of adjustments.

The undersigned taxpayer(s), in accordance with IRC sections 6224(b) and 6213(d), also waive the restrictions provided by IRC sections 6225(a) and 6213(a) and consent to the assessment and collection of any deficiency attributable to partnership items, penalties, additions to tax, and additional amounts that relate to partnership items, as determined in this agreement; plus any interest provided by law.

This agreement is conditional and will not become effective or final until this agreement form is returned to the Commissioner and is signed on his or her behalf. The one-year extension of the period of limitations on assessments under IRC section 6229(f) will not begin to run until the date the Commissioner's representative signs this form on the Commissioner's behalf. If this is a partial agreement, the period of limitations for assessing any tax attributable to the settled items shall be determined as if this agreement had not been entered into.

If this part of this agreement form is signed for the Commissioner, the treatment of partnership items and partnership level determinations as to penalties, additions to tax and additional amounts that relate to adjustments to partnership items under this agreement will not be reopened in absence of fraud, malfeasance, or misrepresentation of fact. In addition, no claim for an adjustment of partnership items, refund or credit based on any change in the treatment of partnership items or partnership level determinations as to penalties, additions to tax and additional amounts may be filed or prosecuted.

Signature of Taxpayer	Date Signed
Signature of Taxpayer	Date Signed
By (Signature and Title)	Date Signed

FOR INTERNAL REVENUE USE ONLY	Date accepted for Commissioner	Signature
	Office	Title

INSTRUCTIONS FOR SIGNING FORM 870-PT

1. If a JOINT RETURN OF A HUSBAND AND WIFE was filed and both spouses intend to agree, both spouses should sign Form 870-PT. One spouse may sign as agent for the other if acting under a power of attorney, which, if not previously filed, must accompany this form. The IRS may accept the signature of only one spouse at its discretion. However, the agreement will only be binding on the signing spouse.

2. If the taxpayer is a corporation, the agreement should be signed with the corporate name followed by the signature and title of the officer authorized to sign Form 870-PT.

3. Your attorney or agent may sign for you if this action is specifically authorized by a power of attorney, which if not previously filed, must accompany this form.

4. If this offer is signed by a trust, the agreement must be signed with the trust name, followed by the signature and title of the person authorized to sign on behalf of the trust.

5. If this offer is with respect to the tax liability for the consolidated return year, the agreement should be signed in the name of the common parent of the consolidated group for the consolidated return year. The common parent corporation signs the agreement in its own name. The signature and title of a current officer of the common parent corporation, who is authorized to bind the corporation, should be displayed in the signature block.

6. If the Tax Matters Partner signs this offer, please include the title with the signature.

7. If this offer is signed by a Tax Matters Partner that is a subsidiary corporation, then an officer authorized to sign this agreement for the year(s) indicated on the form must sign for the parent corporation. An authorized officer for the subsidiary corporation should also sign if the Tax Matters Partner is binding non-notice partners under the agreement. See Treas. Reg. 1.1502-77(a)(3)(v).

DEPARTMENT OF THE TREASURY - INTERNAL REVENUE SERVICE

Agreement for Partnership Items and Partnership Level Determinations as to Penalties, Additions to Tax, and Additional Amounts

SCHEDULE OF ADJUSTMENTS

NAME OF PARTNERSHIP

SA Tesoro Investment Partners

TAXPAYER IDENTIFYING NUMBER: 74-2936192

DETAIL OF ADJUSTMENTS TO ORDINARY INCOME	TAX YEAR(S) ENDED December 31, 1999		
a. Net Gain (Loss) from Form 4797, Part II, Line 18	(50,000.00)		
TOTAL ADJUSTMENTS TO ORDINARY INCOME	(50,000.00)		
OTHER ADJUSTMENTS			
A. Outside Partnership Basis			
(1) ADJUSTMENT	-		
(2) AS REPORTED	-		
(3) CORRECTED	-		
B. Tax-Exempt Interest Income			
(1) ADJUSTMENT	(958.00)		
(2) AS REPORTED	958.00		
(3) CORRECTED	0.00		

REMARKS

- Reference Exhibit A attached.

Accuracy Penalties under IRC Section 6662 are included as a partnership level determination. See Exhibit A, Paragraph 9, for a description of the penalties.

EXHIBIT A—Explanation of Items
SA Tesoro Investment Partners
Final Partnership Administrative Adjustment Letter
Tax Year: November 12 to December 27, 1999
EIN: 74-2936192

1. It is determined that neither **SA Tesoro Investments Partners** nor its purported partners have established the existence of **SA Tesoro Investments Partners** as partnership as a matter of fact.

2. Even if **SA Tesoro Investments Partners** existed as a partnership, the purported partnership was formed and availed of solely for purposes of tax avoidance by artificially overstating basis in the partnership interests of its purported partners. The formation of **SA Tesoro Investments Partners**, the acquisition of any interest in the purported partnership by the purported partner, the purchase of offsetting options, the transfer of offsetting options to a partnership in return for a partnership interest, the purchase of assets by the partnership, and the distribution of those assets to **SA Tesoro Drive Investors Inc.** in complete liquidation of the partnership interests, and the subsequent sale of those assets to generate a loss, all within a period of less than 2 Months, had no business purpose other than tax avoidance, lacked economic substance, and, in fact and substance, constitutes an economic sham for federal income tax purposes. Accordingly, the partnership and the transactions described above shall be disregarded in full and **any purported losses resulting from these transactions are**

not allowable as deductions for federal income tax purposes.

3. It is determined that **SA Tesoro Investments Partners** was a sham, lacked economic substance and, under § 1.701-2 of the Income Tax Regulations, was formed and availed of in connection with a transaction or transactions in taxable year **November 12 to December 27, 1999**, a principal purpose of which was to reduce substantially the present value of its partners' aggregate federal tax liability in a manner that is inconsistent with the intent of Subchapter K of the Internal Revenue Code. It is consequently determined that:

   a. **SA Tesoro Investments Partners** is disregarded and that all transactions engaged in by the purported partnership are treated as engaged in directly by its purported partners. This includes the determination that the assets purportedly acquired by **SA Tesoro Investments Partners**, including but not limited to foreign currency options, were acquired directly by the purported partners.

   b. the foreign currency option(s), purportedly contributed to or assumed by **SA Tesoro Investments Partners**, are treated as never having been contributed to or assumed by said partnership and any gains or losses purportedly realized by **SA Tesoro Investments Partners** on the option(s) are treated as having been realized by its partners.

   c. the purported partners of **SA Tesoro Investments Partners** should be treated as not being partners in **SA Tesoro Investment Partners**.

d. contributions to **SA Tesoro Investments Partners** will be adjusted to reflect clearly the partnership's or purported partners' income.

4. It is determined that the **obligations under the** short positions (written call options) transferred to **SA Tesoro Investments Partners** constitute liabilities for purposes of Treasury Regulation § 1.752-6T, the assumption of which by **SA Tesoro Investments Partners** shall reduce the purported partners' bases **for GW Tesoro Inv. LLC, Gary Woods, single member and BJM Tesoro Drive Inv. LLC, and Billy J. McCombs, single member** in the amounts of **$3,135,000 and $28,215,000,** respectively but not below the fair market value of the purported partnership interest.

5. It is determined that neither **SA Tesoro Investments Partners** nor its purported partners entered into the option(s) positions or purchase the foreign currency or stock with a profit motive for purposes of § 165(c)(2).

6. It is determined that, even if the foreign currency option(s) are tested as having been contributed to **SA Tesoro Investments Partners,** the amount treated as contributed by the partners under section 722 of the Internal Revenue Code is reduced by the amounts received by the contributing partners from the contemporaneous sales of the call option(s) to the same counter-party. Thus, the basis of the contributed option(s) is reduced, both in the hands of the contributing partners and **SA Tesoro Investments Partners.** Consequently, any corresponding claimed increases in the outside basis in **SA Tesoro Investments Partners**

resulting from the contributions of the foreign currency option(s) are disallowed.

7. It is determined that the adjusted bases of the long call positions (purchased call options), and other contributions purportedly contributed by the partners to **SA Tesoro Investments Partners** has not been established under I.R.C. § 723. It is consequently determined that the partners of **SA Tesoro Investment Partners** have not established adjusted bases in their respective partnership interests in an amount greater than zero (-0-).

8. It is further determined that, in the case of a sale, exchange, or liquidation of **SA Tesoro Investments Partners** partners' partnership interests, neither the purported partnership nor its purported partners have established that the bases of the partners' partnership interests were greater than zero for purposes of determining gain or loss to such partners from the sale, exchange, or liquidation of such partnership interest.

9. Accuracy-Related Penalties

   It is determined that the adjustments of partnership items of **SA Tesoro Investments Partners** are attributable to a tax shelter for which no substantial authority has been established for the position taken, and for which there was no showing of reasonable belief by the partnership or its partners that the position taken was more likely than not the correct treatment of the tax shelter and related transactions. In addition, all of the underpayments of tax resulting from those ad-

justments of partnership items are attributable to, at a minimum, (1) substantial understatements of income tax, (2) gross valuation misstatement(s), or (3) negligence or disregarded rules or regulations. There has not been a showing by the partnership or any of its partners that there was reasonable cause for any of the resulting underpayments, that the partnership or any of its partners acted in good faith, or that any other exceptions to the penalty apply. It is therefore determined that, at a minimum, the accuracy-related penalty under Section 6662(a) of the Internal Revenue Code applies to all underpayments of tax attributable to adjustments of partnership items of **SA Tesoro Investments Partners**. The penalty shall be imposed on the components of underpayments as follows.

A. a 40 percent penalty shall be imposed on the portion of any underpayment attributable to the gross valuation misstatement as provided by Sections 6662(a), 6662(b)(3), 6662(e), and 6662(h) of the Internal Revenue Code.

B. a 20 percent penalty shall be imposed on the portion of the underpayment attributable to negligence or disregard of rules and regulations as provided by Sections 6662(a), 6662(b)(1), 6662(c) of the Internal Revenue Code.

C. a 20 percent penalty shall be imposed on the underpayment attributable to the substantial understatement of income tax as provided by sections

6662(a), 6662(b)(2), and 6662(d) of the Internal Revenue Code.

D. a 20 percent penalty shall be imposed on the underpayment attributable to the substantial valuation misstatement as provided by Sections 6662(a), 6662(b)(3), and 6662(e) of the Internal Revenue Code.

It should not be inferred by the determination of the Accuracy Related Penalty in this notice that fraud penalties will not be sought on any portion of an underpayment subsequently determined to be attributable to fraud or that prosecution for criminal offenses will not be sought under IRC § 7201, 7206 or other provisions of federal law if determined to be appropriate.

Mar. 17, 2005

Via U.S. Mail

Internal Revenue Service
Austin, Texas, 73301-0011

Re: Tax Matters Partner Designation for SA Tesoro Investment Partners, Employer Identification Number 74-2936192

Dear Sir or Madam:

This letter is for the purpose of designating a tax matters partner under Treasury Regulation § 301.6231(a)(7)-1 for S.A. Tesoro Investment Partners ("S.A. Tesoro") with employer identification number 74-2936192. The principal place of business and address for S.A. Tesoro is 755 East Mulberry, Suite 600, San Antonio, Texas 78212. For the tax year ending December 27, 1999, GW Tesoro Investments, LLC ("GW") and BJM Tesoro Drive Investments, LLC ("BJM") are general partners of S.A. Tesoro with GW owning a 10% general partnership interest and BJM owning a 90% general partnership interest.

For this same tax year both GW and BJM are single member limited liability companies which, under Treas. Reg. § 301.7701-2(c)(2), are disregarded for federal tax purposes. The sole member of GW is Gary Woods. The sole member of BJM is Billy McCombs. Both GW and BJM have dissolved since the close of the 1999 tax year.

Pursuant to Treasury Regulation § 301.6231(a)(7)-1, S.A. Tesoro hereby designates Gary Woods, as the sole member of the now dissolved GW, as its tax matters partner. In accordance with Treasury Regulation 301.6231(a)(7)-1(e) and 301.6231(a)(7)-1(f)(2), this letter is signed by Billy J. McCombs, as the sole member of BJM, which is shown on the return to own more than 50% of the aggregate interest in partnership profits held by all partners.

The address for GW and Gary Woods is 755 E. Mulberry, Suite 600, San Antonio, Texas 78212. The federal employer identification number for GW is 74-2936194. The Social Security Number for Gary Woods is [REDACTED].

The address for BJM and Billy J. McCombs is also at 755 E. Mulberry, Suite 600, San Antonio, Texas 78217. The federal employer identification number for BJM is 74-2936195. The Social Security Number for Billy J. McCombs is [REDACTED].

/s/ BILLY J. McCOMBS
BILLY J. MCCOMBS, Sole Member
Of BJM Tesoro Drive Investments LLC

MEADOWS, OWENS, COLLIER, REED, COUSINS & BLAU, L.L.P.
ATTORNEYS AT LAW
A REGISTERED LIMITED LIABILITY PARTNERSHIP
INCLUDING PROFESSIONAL CORPORATIONS
901 MAIN STREET, SUITE 3700
DALLAS, TEXAS 75202
(214) 744-3700
www.meadowsowens.com

DAVID E. COLMENERO
Associate

FAX (214) 747-3732
WATS (800) 451-0093
dcolmenero@meadowsowens.com

Feb. 2, 2005

VIA FEDERAL EXPRESS

Stella Pullin, Operations Manager
Internal Revenue Service
3651 S. Interregional Hwy.
Austin, Tx 78741

Re: Cash Deposit under IRC Section 6603 and 6226(e) Gary Woods and Glenda M. Woods: SSN [REDACTED] and [REDACTED]

Dear Ms. Pullin:

Enclosed as a cash deposit made pursuant to Section 6226(e) and Section 6603 of the Internal Revenue Code, is a check in the amount of $906,934.00. The check is numbered 2170 and is drawn on Frost National Bank. This amount is deposited with respect to income tax for the above taxpayers' period December 31, 1999 with $762,810.00 representing tax and $144,124.00 represent-

ing interest. This payment is remitted in satisfaction of the jurisdictional deposit required under Section 6226(e) of the Internal Revenue Code.

Solely for the purposes of complying with Section 6603, the taxpayers reasonably estimate that, out of the deposited amount, the maximum amount of any tax attributable to disputable items for the period ended December 31, 1999 is $762,810.00. The remaining amount represents interest. The taxpayers do not concede liability, and nothing contained herein should be construed as a concession of any tax, penalty or interest liability.

Please date-stamp the copy of the attached check and sign a copy of this letter and return it to me in the enclosed self-addressed, stamped envelope.

Yours very truly,

/s/ DAVID E. COLMENERO
DAVID E. COLMENERO

DEC: 314331
Enclosures

cc: Joel N. Crouch (*of the Firm*)
Gary Woods

ACKNOWLEDGED AND RECEIVED:

By: _____

Printed Name: _____

Date: _____

Internal Revenue Service

MEADOWS, OWENS, COLLIER, REED, COUSINS & BLAU, L.L.P.
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DALLAS, TEXAS 75202
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www.meadowsowens.com

DAVID E. COLMENERO
Associate

FAX (214) 747-3732
WATS (800) 451-0093
dcolmenero@meadowsowens.com

February 2, 2005

VIA FEDERAL EXPRESS
Stella Pullin, Operations Manager
Internal Revenue Service
3651 S. Interregional Hwy.
Austin, Tx 78741

Re: Cash Deposit under IRC Section 6603 and 6226(e) Gary Woods and Glenda M. Woods: SSN 463-60-1990 and 456-74-1475

Dear Ms. Pullin:

Enclosed as a cash deposit made pursuant to Section 6226(e) and Section 6603 of the Internal Revenue Code, is a check in the amount of $3,993,117.00 The check is numbered 2169 and is drawn on Frost National Bank. This amount is deposited with respect to income tax for the above taxpayers' period December 31, 1999 with

$3,358,556 representing tax and $634,561.00 representing interest. This payment is remitted in satisfaction of the jurisdictional deposit required under Section 6226(e) of the Internal Revenue Code.

Solely for the purposes of complying with Section 6603, the taxpayers reasonably estimate that, out of the deposited amount, the maximum amount of any tax attributable to disputable items for the period ended December 31, 1999 is $3,993,117.00. The remaining amount represents interest. The taxpayers do not concede liability, and nothing contained herein should be construed as a concession of any tax, penalty or interest liability.

Please date-stamp the copy of the attached check and sign a copy of this letter and return it to me in the enclosed self-addressed, stamped envelope.

Yours very truly,

/s/ DAVID E. COLMENERO
DAVID E. COLMENERO

DEC: 314330
Enclosures

cc: Joel N. Crouch (*of the Firm*)
Gary Woods

ACKNOWLEDGED AND RECEIVED:
By: _____
Printed Name: _____
Date: _____
Internal Revenue Service

Department of the Treasury
Internal Revenue Service

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Date October 1, 2007

CERTIFICATE OF OFFICIAL RECORD

I certify that the annexed: is a and complete copy of the U. S. Income Tax Return of Income (Form 1065) for SA Tesoro Investment Partners, EIN: 74-2936192, 9000 Tesoro Drive, Suite 122, San Antonio, Texas 78217, for calendar year beginning November 12, 1999 and ending December 27, 1999, which was received in the regular course of business of the Internal Revenue Service and consists of fifth teen (15) pages

under the custody of this office.

IN WITNESS WHEREOF, I have hereunto set my hand, and caused the seal of this office to be affixed, on the day and year first above written.

By direction of the Secretary of the Treasury:

Thomas D. Mathews
Director Advisory, Insolvency & Quality
Small Business Self Employed Division

for Felix J. Carrillo Jr.
Technical Services Group Manager, Houston
Small Business Self Employed Division

Form 2866

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DEFENDANT'S EXHIBIT 246

SHORT YEAR FINAL INITIAL RETURN

Form 1065 U.S. Partnership Return of Income

For calendar year 1999, or tax year beginning 11/12, 1999, and ending 12/27, 1999

▶ See separate instructions

OMB No. 1545-0099

1999

A Principal business activity: INVESTMENTS	Name of partnership: SA TESORO INVESTMENT PARTNERS
B Principal product or service: INVESTMENTS	Number, street, and room or suite no. (If a P.O. box, see page 12 of the instructions): 9000 TESORO DRIVE SUITE 122
C Business code number: 523900	City or town, state, and ZIP code: SAN ANTONIO TX 78217
D Employer identification number: 74-2936192	
E Date business started: 11/12/1999	
F Total assets (see page 12 of the instructions): $	

G Check applicable boxes: (1) [X] Initial return (2) [X] Final return (3) [ ] Change in address (4) [ ] Amended return

H Check accounting method: (1) [X] Cash (2) [ ] Accrual (3) [ ] Other (specify) ▶

I Number of Schedules K-1. Attach one for each person who was a partner at any time during the tax year ▶ 2

Caution: *Include only trade or business income and expenses on lines 1a through 22 below. See the instructions for more information.*

Income	1 a Gross receipts or sales	1a			
	b Less returns and allowances	1b		1c	
	2 Cost of goods sold (Schedule A, line 8)			2	
	3 Gross profit. Subtract line 2 from line 1c			3	
	4 Ordinary income (loss) from other partnerships, estates, and trusts (attach schedule)			4	
	5 Net farm profit (loss) (attach Schedule F (Form 1040))			5	
	6 Net gain (loss) from Form 4797, Part II, line 18			6	50,000.
	7 Other income (loss) (attach schedule)			7	
	8 Total income (loss). Combine lines 3 through 7			8	50,000.
Deductions (see page 11 of the instructions for limitations)	9 Salaries and wages (other than to partners) (less employment credits)			9	
	10 Guaranteed payments to partners			10	
	11 Repairs and maintenance			11	
	12 Bad debts			12	
	13 Rent			13	
	14 Taxes and licenses			14	
	15 Interest			15	
	16 a Depreciation (if required, attach Form 4562)	16a			
	b Less depreciation reported on Schedule A and elsewhere on return	16b		16c	
	17 Depletion (Do not deduct oil and gas depletion.)			17	
	18 Retirement plans, etc.			18	
	19 Employee benefit programs			19	
	20 Other deductions (attach schedule)			20	
	21 Total deductions. Add the amounts shown in the far right column for lines 9 through 20			21	
	22 Ordinary income (loss) from trade or business activities. Subtract line 21 from line 8			22	50,000.

RECEIVED 2000 AUSTIN, TX

Please Sign Here

Under penalties of perjury, I declare that I have examined this return, including accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete. Declaration of preparer (other than general partner or limited liability company member) is based on all information of which preparer has any knowledge.

▶ Signature of general partner or limited liability company member — ▶ Date: 3-27-00

Paid Preparer's Use Only

Preparer's signature ▶ Stewart Andrew, CPA	Date: 3/27/00	Check if self-employed ▶ [ ]	Preparer's SSN or PTIN: P00884467
Firm's name (or yours if self-employed) and address ▶ ERNST & YOUNG LLP, 1150 18TH STREET NW, SUITE 500, WASHINGTON, DC			EIN ▶ 34-6565596; ZIP code ▶ 20036-0000

For Paperwork Reduction Act Notice, see separate instructions. Form **1065** (1999)

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Schedule A **Cost of Goods Sold** (see page 17 of the instructions)

1	Inventory at beginning of year	1	
2	Purchases less cost of items withdrawn for personal use	2	
3	Cost of labor	3	
4	Additional section 263A costs *(attach schedule)*	4	
5	Other costs *(attach schedule)*	5	
6	Total. Add lines 1 through 5	6	
7	Inventory at end of year	7	
8	**Cost of goods sold.** Subtract line 7 from line 6. Enter here and on page 1, line 2	8	

9 a Check all methods used for valuing closing inventory:
- (i) ☐ Cost as described in Regulations section 1.471-3
- (ii) ☐ Lower of cost or market as described in Regulations section 1.471-4
- (iii) ☐ Other (specify method used and attach explanation) ▶

b Check this box if there was a writedown of "subnormal" goods as described in Regulations section 1.471-2(c) ▶ ☐

c Check this box if the LIFO inventory method was adopted this tax year for any goods *(if checked, attach Form 970)* ▶ ☐

d Do the rules of section 263A (for property produced or acquired for resale) apply to the partnership? ☐ Yes ☐ No

e Was there any change in determining quantities, cost, or valuations between opening and closing inventory? ☐ Yes ☐ No
If "Yes," attach explanation.

Schedule B **Other Information**

		Yes	No
1	What type of entity is filing this return? Check the applicable box: a ☒ General partnership b ☐ Limited partnership c ☐ Limited liability company d ☐ Limited liability partnership e ☐ Other ▶		
2	Are any partners in this partnership also partnerships?		X
3	Is this partnership a partner in another partnership?		X
4	Is this partnership subject to the consolidated audit procedures of sections 6221 through 6233? If "Yes," see **Designation of Tax Matters Partner** below		X
5	Does this partnership meet **ALL THREE** of the following requirements?		
a	The partnership's total receipts for the tax year were less than $250,000.		
b	The partnership's total assets at the end of the tax year were less than $600,000; **AND**		
c	Schedules K-1 are filed with the return and furnished to the partners on or before the due date (including extensions) for the partnership return. If "Yes," the partnership is not required to complete Schedules L, M-1, and M-2, Item F on page 1 of Form 1065, or Item J on Schedule K-1	X	
6	Does this partnership have any foreign partners?		X
7	Is this partnership a publicly traded partnership as defined in section 469(k)(2)?		X
8	Has this partnership filed, or is it required to file, **Form 8264**, Application for Registration of a Tax Shelter?		X
9	At any time during calendar year 1999, did the partnership have an interest in or a signature or other authority over a financial account in a foreign country (such as a bank account, securities account, or other financial account)? See page 18 of the instructions for exceptions and filing requirements for Form TD F 90-22.1. If "Yes," enter the name of the foreign country ▶		X
10	During the tax year, did the partnership receive a distribution from, or was it the grantor of, or transferor to, a foreign trust? If "Yes," the partnership may have to file Form 3520. See page 18 of the instructions		X
11	Was there a distribution of property or a transfer (e.g., by sale or death) of a partnership interest during the tax year? If "Yes," you may elect to adjust the basis of the partnership's assets under section 754 by attaching the statement described under **Elections Made By the Partnership** on page 7 of the instructions	X	

Designation of Tax Matters Partner (see page 18 of the instructions)

Enter below the general partner designated as the tax matters partner (TMP) for the tax year of this return:

Name of designated TMP ▶ _____ Identifying number of TMP ▶ _____

Address of designated TMP ▶ _____

JSA
9P1070 2 000

JW2758 1266 03/20/2000 10:49:05 V9.06.01 600-79102 3

6.0003

Schedule K Partners' Shares of Income, Credits, Deductions, etc.

			(a) Distributive share items		(b) Total amount
Income (Loss)	1		Ordinary income (loss) from trade or business activities (page 1, line 22)	1	50,000.
	2		Net income (loss) from rental real estate activities (attach Form 8825)	2	
	3a		Gross income from other rental activities 3a		
		b	Expenses from other rental activities (attach schedule) 3b		
		c	Net income (loss) from other rental activities. Subtract line 3b from line 3a	3c	
	4		Portfolio income (loss)		
		a	Interest income	4a	
		b	Ordinary dividends	4b	
		c	Royalty income	4c	
		d	Net short-term capital gain (loss) (attach Schedule D (Form 1065))	4d	
		e	Net long-term capital gain (loss) (attach Schedule D (Form 1065))		
			(1) 28% rate gain (loss) ▶ (2) Total for year ▶	4e(2)	
		f	Other portfolio income (loss) (attach schedule)	4f	
	5		Guaranteed payments to partners	5	
	6		Net section 1231 gain (loss) (other than due to casualty or theft) (attach Form 4797)	6	
	7		Other income (loss) (attach schedule)	7	
Deductions	8		Charitable contributions (attach schedule)	8	
	9		Section 179 expense deduction (attach Form 4562)	9	
	10		Deductions related to portfolio income (itemize)	10	
	11		Other deductions (attach schedule)	11	
Credits	12a		Low-income housing credit		
			(1) From partnerships to which section 42(j)(5) applies for property placed in service before 1990	12a(1)	
			(2) Other than on line 12a(1) for property placed in service before 1990	12a(2)	
			(3) From partnerships to which section 42(j)(5) applies for property placed in service after 1989	12a(3)	
			(4) Other than on line 12a(3) for property placed in service after 1989	12a(4)	
		b	Qualified rehabilitation expenditures related to rental real estate activities (attach Form 3468)	12b	
		c	Credits (other than credits shown on lines 12a and 12b) related to rental real estate activities	12c	
		d	Credits related to other rental activities	12d	
	13		Other credits	13	
Investment Interest	14a		Interest expense on investment debts	14a	
		b	(1) Investment income included on lines 4a, 4b, 4c, and 4f above	14b(1)	
			(2) Investment expenses included on line 10 above	14b(2)	
Self-Employment	15a		Net earnings (loss) from self-employment	15a	
		b	Gross farming or fishing income	15b	
		c	Gross nonfarm income	15c	
Adjustments and Tax Preference Items	16a		Depreciation adjustment on property placed in service after 1986	16a	
		b	Adjusted gain or loss	16b	
		c	Depletion (other than oil and gas)	16c	
		d	(1) Gross income from oil, gas, and geothermal properties	16d(1)	
			(2) Deductions allocable to oil, gas, and geothermal properties	16d(2)	
		e	Other adjustments and tax preference items (attach schedule)	16e	
Foreign Taxes	17a		Type of income ▶		
		b	Name of foreign country or U.S. possession ▶		
		c	Total gross income from sources outside the United States (attach schedule)	17c	
		d	Total applicable deductions and losses (attach schedule)	17d	
		e	Total foreign taxes (check one) ▶ ☐ Paid ☐ Accrued	17e	
		f	Reduction in taxes available for credit (attach schedule)	17f	
		g	Other foreign tax information (attach schedule)	17g	
Other	18		Section 59(e)(2) expenditures a Type ▶ ▶ Amount ▶	18b	
	19		Tax-exempt interest income SEE STATEMENT 1.	19	958.
	20		Other tax-exempt income	20	
	21		Nondeductible expenses	21	
	22		Distributions of money (cash and marketable securities)	22	
	23		Distributions of property other than money	23	
	24		Other items and amounts required to be reported separately to partners (attach schedule)		

Form 1065 (1999)

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Analysis of Net Income (Loss)

1	Net income (loss). Combine Schedule K, lines 1 through 7 in column (b). From the result, subtract the sum of Schedule K, lines 8 through 11, 14a, 17e, and 18b					1	50,000.
2	Analysis by partner type	(i) Corporate	(ii) Individual (active)	(iii) Individual (passive)	(iv) Partnership	(v) Exempt organization	(vi) Nominee/Other
a	General partners		50,000.				
b	Limited partners						

Schedule L Balance Sheets per Books (Not required if Question 5 on Schedule B is answered "Yes.")

Assets	Beginning of tax year (a)	Beginning of tax year (b)	End of tax year (c)	End of tax year (d)
1 Cash				
2a Trade notes and accounts receivable				
b Less allowance for bad debts				
3 Inventories				
4 U.S. government obligations				
5 Tax-exempt securities				
6 Other current assets (attach schedule)				
7 Mortgage and real estate loans				
8 Other investments (attach schedule)				
9a Buildings and other depreciable assets				
b Less accumulated depreciation				
10a Depletable assets				
b Less accumulated depletion				
11 Land (net of any amortization)				
12a Intangible assets (amortizable only)				
b Less accumulated amortization				
13 Other assets (attach schedule)				
14 Total assets				
Liabilities and Capital				
15 Accounts payable				
16 Mortgages, notes, bonds payable in less than 1 year				
17 Other current liabilities (attach schedule)				
18 All nonrecourse loans				
19 Mortgages, notes, bonds payable in 1 year or more				
20 Other liabilities (attach schedule)				
21 Partners' capital accounts				
22 Total liabilities and capital				

Schedule M-1 Reconciliation of Income (Loss) per Books With Income (Loss) per Return

(Not required if Question 5 on Schedule B is answered "Yes." See page 29 of the instructions.)

1	Net income (loss) per books	6	Income recorded on books this year not included on Schedule K, lines 1 through 7 (itemize):
2	Income included on Schedule K, lines 1 through 4, 6, and 7, not recorded on books this year (itemize):	a	Tax-exempt interest $
3	Guaranteed payments (other than health insurance)	7	Deductions included on Schedule K, lines 1 through 11, 14a, 17e, and 18b, not charged against book income this year (itemize):
4	Expenses recorded on books this year not included on Schedule K, lines 1 through 11, 14a, 17e, and 18b (itemize):	a	Depreciation $
a	Depreciation $	8	Add lines 6 and 7
b	Travel and entertainment $	9	Income (loss) (Analysis of Net Income (Loss), line 1). Subtract line 8 from line 5
5	Add lines 1 through 4		

Schedule M-2 Analysis of Partners' Capital Accounts (Not required if Question 5 on Schedule B is answered "Yes.")

1	Balance at beginning of year	6	Distributions: a Cash
2	Capital contributed during year		b Property
3	Net income (loss) per books	7	Other decreases (itemize):
4	Other increases (itemize):	8	Add lines 6 and 7
5	Add lines 1 through 4	9	Balance at end of year. Subtract line 8 from line 5

Form **4797**

Department of the Treasury
Internal Revenue Service (99)

Sales of Business Property
(Also Involuntary Conversions and Recapture Amounts Under Sections 179 and 280F(b)(2))

▶ Attach to your tax return. ▶ See separate instructions.

OMB No. 1545-0184

1999

Attachment Sequence No. 27

Name(s) shown on return

SA TESORO INVESTMENT PARTNERS

Identifying number

74-2936192

1 Enter here the gross proceeds from the sale or exchange of real estate reported to you for 1999 on Form(s) 1099-S (or a substitute statement) that you will be including on line 2, 10, or 20 1

Part I Sales or Exchanges of Property Used in a Trade or Business and Involuntary Conversions From Other Than Casualty or Theft - Property Held More Than 1 Year

(a) Description of property	(b) Date acquired (mo., day, yr.)	(c) Date sold (mo., day, yr.)	(d) Gross sales price	(e) Depreciation allowed or allowable since acquisition	(f) Cost or other basis, plus improvements and expense of sale	(g) GAIN or (LOSS) Subtract (f) from the sum of (d) and (e)
2						

3	Gain, if any, from Form 4684, line 39	3
4	Section 1231 gain from installment sales from Form 6252, line 26 or 37	4
5	Section 1231 gain or (loss) from like-kind exchanges from Form 8824	5
6	Gain, if any, from line 32, from other than casualty or theft	6
7	Combine lines 2 through 6. Enter gain or (loss) here and on the appropriate line as follows	7

Partnerships (except electing large partnerships). Report the gain or (loss) following the instructions for Form 1065, Schedule K, line 6. Skip lines 8, 9, 11, and 12 below.

S corporations. Report the gain or (loss) following the instructions for Form 1120S, Schedule K, lines 5 and 6. Skip lines 8, 9, 11, and 12 below, unless line 7 is a gain and the S corporation is subject to the capital gains tax.

All others. If line 7 is zero or a loss, enter the amount from line 7 on line 11 below and skip lines 8 and 9. If line 7 is a gain and you did not have any prior year section 1231 losses, or they were recaptured in an earlier year, enter the gain from line 7 as a long-term capital gain on Schedule D and skip lines 8, 9, and 12 below.

8	Nonrecaptured net section 1231 losses from prior years (see instructions)	8
9	Subtract line 8 from line 7. If zero or less, enter -0-. Also enter on the appropriate line as follows (see instructions)	9

S corporations. Enter any gain from line 9 on Schedule D (Form 1120S), line 14, and skip lines 11 and 12 below.

All others. If line 9 is zero, enter the gain from line 7 on line 12 below. If line 9 is more than zero, enter the amount from line 8 on line 12 below, and enter the gain from line 9 as a long-term capital gain on Schedule D.

Part II Ordinary Gains and Losses

10 Ordinary gains and losses not included on lines 11 through 17 (include property held 1 year or less)

SEE STATEMENT 2						50,000.

11	Loss, if any, from line 7	11	( )
12	Gain, if any, from line 7 or amount from line 8, if applicable	12	
13	Gain, if any, from line 31	13	
14	Net gain or (loss) from Form 4684, lines 31 and 38a	14	
15	Ordinary gain from installment sales from Form 6252, line 25 or 36	15	
16	Ordinary gain or (loss) from like-kind exchanges from Form 8824	16	
17	Recapture of section 179 expense deduction for partners and S corporation shareholders from property dispositions by partnerships and S corporations (see instructions)	17	
18	Combine lines 10 through 17. Enter the gain or (loss) here, and on the appropriate line as follows	18	50,000.
a	For all except individual returns: Enter the gain or (loss) from line 18 on the return being filed.		
b	For individual returns:		
(1)	If the loss on line 11 includes a loss from Form 4684, line 35, column (b)(ii), enter that part of the loss here. Enter the part of the loss from income-producing property on Schedule A (Form 1040), line 27, and the part of the loss from property used as an employee on Schedule A (Form 1040), line 22. Identify as from "Form 4797, line 18b(1)." See instructions	18b(1)	
(2)	Redetermine the gain or (loss) on line 18, excluding the loss, if any, on line 18b(1). Enter here and on Form 1040, line 14	18b(2)	

For Paperwork Reduction Act Notice, see separate instructions. Form **4797** (1999)

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Part III **Gain From Disposition of Property Under Sections 1245, 1250, 1252, 1254, and 1255**

19 (a) Description of section 1245, 1250, 1252, 1254, or 1255 property	(b) Date acquired (mo., day, yr.)	(c) Date sold (mo., day, yr.)
A		
B		
C		
D		

These columns relate to the properties on lines 19A through 19D. ▶		Property A	Property B	Property C	Property D
20 Gross sales price (Note: See line 1 before completing.)	20				
21 Cost or other basis plus expense of sale	21				
22 Depreciation (or depletion) allowed or allowable	22				
23 Adjusted basis. Subtract line 22 from line 21	23				
24 Total gain. Subtract line 23 from line 20	24				
25 If section 1245 property:					
a Depreciation allowed or allowable from line 22	25a				
b Enter the smaller of line 24 or 25a	25b				
26 If section 1250 property: If straight line depreciation was used, enter -0- on line 26g, except for a corporation subject to section 291.					
a Additional depreciation after 1975 (see instructions)	26a				
b Applicable percentage multiplied by the smaller of line 24 or line 26a (see instructions)	26b				
c Subtract line 26a from line 24. If residential rental property or line 24 is not more than line 26a, skip lines 26d and 26e	26c				
d Additional depreciation after 1969 and before 1976	26d				
e Enter the smaller of line 26c or 26d	26e				
f Section 291 amount (corporations only)	26f				
g Add lines 26b, 26e, and 26f	26g				
27 If section 1252 property: Skip this section if you did not dispose of farmland or if this form is being completed for a partnership (other than an electing large partnership).					
a Soil, water, and land clearing expenses	27a				
b Line 27a multiplied by applicable percentage (see instructions)	27b				
c Enter the smaller of line 24 or 27b	27c				
28 If section 1254 property:					
a Intangible drilling and development costs, expenditures for development of mines and other natural deposits, and mining exploration costs (see instructions)	28a				
b Enter the smaller of line 24 or 28a	28b				
29 If section 1255 property:					
a Applicable percentage of payments excluded from income under section 126 (see instructions)	29a				
b Enter the smaller of line 24 or 29a (see instructions)	29b				

Summary of Part III Gains. Complete property columns A through D through line 29b before going to line 30.

30 Total gains for all properties. Add property columns A through D, line 24	30	
31 Add property columns A through D, lines 25b, 26g, 27c, 28b, and 29b. Enter here and on line 13	31	
32 Subtract line 31 from line 30. Enter the portion from casualty or theft on Form 4684, line 33. Enter the portion from other than casualty or theft on Form 4797, line 6	32	

Part IV **Recapture Amounts Under Sections 179 and 280F(b)(2) When Business Use Drops to 50% or Less** See instructions.

		(a) Section 179	(b) Section 280F(b)(2)
33 Section 179 expense deduction or depreciation allowable in prior years	33		
34 Recomputed depreciation. See instructions	34		
35 Recapture amount. Subtract line 34 from line 33. See the instructions for where to report	35		

20 1 000 JW2758 1266 03/20/2000 10:49:05 V9.06.01 600-79102

SCHEDULE K - LINE 19 - TAX-EXEMPT INTEREST INCOME

TAX EXEMPT MONEY MARKET	958.
TOTAL TAX-EXEMPT INTEREST INCOME	958.

SA TESORO INVESTMENT PARTNERS
FORM 4797 PAGE 1 SUPPORTING SCHEDULES 74-2936192

OTHER ORDINARY GAINS AND LOSSES

DESCRIP. OF PROPERTY	DATE ACQUIRED	DATE SOLD	GROSS SALES PRICE	ALLOWABLE DEPRECIATION	COST/BASIS	LOSS	GAIN
CURRENCY CONTRACT	11/18/99	12/20/99	200,000.		17,200,000.	17,000,000.	
CURRENCY CONTRACT	11/18/99	12/20/99	16,340,000.				16,340,000
CURRENCY CONTRACT	11/18/99	12/20/99	1,250,000.		12,500,000.	11,250,000.	
CURRENCY CONTRACT	11/18/99	12/20/99	11,875,000.				11,875,000.
CURRENCY CONTRACT	11/18/99	12/20/99	250,000.		3,300,000	3,050,000.	
CURRENCY CONTRACT	11/18/99	12/20/99	3,135,000				3,135,000.
TOTAL OTHER ORDINARY GAINS AND LOSSES						31,300,000.	31,350,000.

SB TESORO INVESTMENT PARTNERS 74-2936192

Partner Summary

Partner Number	Partner Name	Partner I D Number	Beginning Profit Ratio	Beginning Loss Ratio	Beginning Ownership Ratio	Beginning Capital	Capital Contributions	Cash Distributions	Property Distributions
1	SB TESORO INV LLC	74-2936194	0.10000000000000	0.10000000000000	0.10000000000000				
2	BJW TESORO DRIVE INV	74-2936195	0.90000000000000	0.90000000000000	0.90000000000000				
	Totals		1.00000000000000	1.00000000000000	1.00000000000000				

JSA

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SHORT YEAR FINAL INITIAL

SCHEDULE K-1 (Form 1065)
Department of the Treasury Internal Revenue Service

Partner's Share of Income, Credits, Deductions, etc.

▶ See separate instructions.

For calendar year 1999 or tax year beginning 11/12, 1999, and ending 12/27/1999

OMB No 1545-0099

1999

Partner's identifying number ▶ 74-2936194	Partnership's identifying number ▶ 74-2936192
Partner's name, address, and ZIP code PARTNER # 1 GW TESORO INV. LLC 9000 TESORO DRIVE, SUITE 122 SUITE 122 SAN ANTONIO, TX 78217	Partnership's name, address, and ZIP code SA TESORO INVESTMENT PARTNERS 9000 TESORO DRIVE SUITE 122 SAN ANTONIO, TX 78217

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A This partner is a [X] general partner [ ] limited partner
[ ] limited liability company member

B What type of entity is this partner? ▶ LIMITED LIAB CO

C Is this partner a [X] domestic or a [ ] foreign partner?

D Enter partner's percentage of

	(i) Before change or termination	(ii) End of year
Profit sharing	10.000000 %NONE	%
Loss sharing	10.000000 %NONE	%
Ownership of capital	10.000000 %NONE	%

E IRS Center where partnership filed return
AUSTIN, TX 73301-0011

F Partner's share of liabilities (see instructions)
Nonrecourse
Qualified nonrecourse financing
Other

G Tax shelter registration number ▶

H Check here if this partnership is a publicly traded partnership as defined in section 469(k)(2) [ ]

I Check applicable boxes (1) [X] Final K-1 (2) [ ] Amended K-1

J **Analysis of partner's capital account:**

(a) Capital account at beginning of year	(b) Capital contributed during year	(c) Partner's share of lines 3, 4, and 7, Form 1065, Schedule M-2	(d) Withdrawals and distributions	(e) Capital account at end of year (combine columns (a) through (d))
			( )	

	(a) Distributive share item		(b) Amount	(c) 1040 filers enter the amount in column (b) on:
Income (Loss)	1 Ordinary income (loss) from trade or business activities	1	5,000.	See page 6 of Partner's Instructions for Schedule K-1 (Form 1065)
	2 Net income (loss) from rental real estate activities	2		
	3 Net income (loss) from other rental activities	3		
	4 Portfolio income (loss)			
	a Interest	4a		Sch. B, Part I, line 1
	b Ordinary dividends	4b		Sch. B, Part II, line 5
	c Royalties	4c		Sch. E, Part I, line 4
	d Net short-term capital gain (loss)	4d		Sch. D, line 5, col. (f)
	e Net long-term capital gain (loss)			
	(1) 28% rate gain (loss)	e(1)		Sch. D, line 12, col. (g)
	(2) Total for year	e(2)		Sch. D, line 12, col. (f)
	f Other portfolio income (loss) *(attach schedule)*	4f		Enter on applicable line of your return
	5 Guaranteed payments to partner	5		See page 6 of Partner's Instructions for Schedule K-1 (Form 1065)
	6 Net section 1231 gain (loss) (other than due to casualty or theft)	6		
	7 Other income (loss) *(attach schedule)*	7		Enter on applicable line of your return
Deductions	8 Charitable contributions (see instructions) *(attach schedule)*	8		Sch. A, line 15 or 16
	9 Section 179 expense deduction	9		
	10 Deductions related to portfolio income *(attach schedule)*	10		See pages 7 and 8 of Partner's Instructions for Schedule K-1 (Form 1065)
	11 Other deductions *(attach schedule)*	11		
Credits	12a Low-income housing credit			
	(1) From section 42(j)(5) partnerships for property placed in service before 1990	a(1)		Form 8586, line 5
	(2) Other than on line 12a(1) for property placed in service before 1990	a(2)		
	(3) From section 42(j)(5) partnerships for property placed in service after 1989	a(3)		
	(4) Other than on line 12a(3) for property placed in service after 1989	a(4)		
	b Qualified rehabilitation expenditures related to rental real estate activities	12b		See page 8 of Partner's Instructions for Schedule K-1 (Form 1065)
	c Credits (other than credits shown on lines 12a and 12b) related to rental real estate activities	12c		
	d Credits related to other rental activities	12d		
	13 Other credits	13		

	(a) Distributive share item		(b) Amount	(c) 1040 filers enter the amount in column (b) on:
Investment Interest	14 a Interest expense on investment debts	14a		Form 4952, line 1 See page 9 of Partner's Instructions for Schedule K-1 (Form 1065)
	b (1) Investment income included on lines 4a, 4b, 4c, and 4f	b(1)		
	(2) Investment expenses included on line 10	b(2)		
Self-employment	15 a Net earnings (loss) from self-employment	15a		Sch. SE, Section A or B See page 9 of Partner's Instructions for Schedule K-1 (Form 1065)
	b Gross farming or fishing income	15b		
	c Gross nonfarm income	15c		
Adjustments and Tax Preference Items	16 a Depreciation adjustment on property placed in service after 1986	16a		See page 9 of Partner's Instructions for Schedule K-1 (Form 1065) and Instructions for Form 6251
	b Adjusted gain or loss	16b		
	c Depletion (other than oil and gas)	16c		
	d (1) Gross income from oil, gas, and geothermal properties	d(1)		
	(2) Deductions allocable to oil, gas, and geothermal properties	d(2)		
	e Other adjustments and tax preference items (attach schedule)	16e		
Foreign Taxes	17 a Type of income ▶			Form 1116, check boxes
	b Name of foreign country or possession ▶			Form 1116, Part I
	c Total gross income from sources outside the United States (attach schedule)	17c		
	d Total applicable deductions and losses (attach schedule)	17d		
	e Total foreign taxes (check one) ▶ ☐ Paid ☐ Accrued	17e		Form 1116, Part II
	f Reduction in taxes available for credit (attach schedule)	17f		Form 1116, Part III
	g Other foreign tax information (attach schedule)	17g		See Instructions for Form 1116
Other	18 Section 59(e)(2) expenditures a Type ▶			See page 9 of Partner's Instructions for Schedule K-1 (Form 1065)
	b Amount	18b		
	19 Tax-exempt interest income SEE STATEMENT 1	19	96.	Form 1040, line 8b
	20 Other tax-exempt income	20		See pages 9 and 10 of Partner's Instructions for Schedule K-1 (Form 1065)
	21 Nondeductible expenses	21		
	22 Distributions of money (cash and marketable securities)	22		
	23 Distributions of property other than money	23		
	24 Recapture of low-income housing credit			
	a From section 42(j)(5) partnerships	24a		Form 8611, line 8
	b Other than on line 24a	24b		

Supplemental Information

25 Supplemental information required to be reported separately to each partner (attach additional schedules if more space is needed)

SA TESORO INVESTMENT PARTNERS 74-2936192
SCHEDULE K-1 SUPPORTING SCHEDULES PARTNER # 1 GW TESORO INV LLC

LINE 19 - TAX-EXEMPT INTEREST INCOME

TAX EXEMPT MONEY MARKET	96.
TOTAL TAX-EXEMPT INTEREST INCOME	96.

SHORT YEAR FINAL INITIAL

SCHEDULE K-1 (Form 1065)
Department of the Treasury Internal Revenue Service

Partner's Share of Income, Credits, Deductions, etc.

▶ See separate instructions.

For calendar year 1999 or tax year beginning 11/12 1999, and ending 12/27/1999

OMB No. 1545-0099

1999

Partner's identifying number ▶ 74-2936195

Partnership's identifying number ▶ 74-2936192

Partner's name, address, and ZIP code PARTNER # 2

BJM TESORO DRIVE INV.
9000 TESORO DRIVE, SUITE 122
SUITE 122
SAN ANTONIO, TX 78217

Partnership's name, address, and ZIP code

SA TESORO INVESTMENT PARTNERS
9000 TESORO DRIVE
SUITE 122
SAN ANTONIO, TX 78217

A This partner is a [X] general partner [ ] limited partner
[ ] limited liability company member

B What type of entity is this partner? ▶ LIMITED LIAB CO

C Is this partner a [X] domestic or a [ ] foreign partner?

D Enter partner's percentage of:

	(i) Before change or termination	(ii) End of year
Profit sharing	90.000000 %	NONE %
Loss sharing	90.000000 %	NONE %
Ownership of capital	90.000000 %	NONE %

E IRS Center where partnership filed return
AUSTIN, TX 73301-0011

F Partner's share of liabilities (see instructions)
Nonrecourse
Qualified nonrecourse financing
Other

G Tax shelter registration number ▶

H Check here if this partnership is a publicly traded partnership as defined in section 469(k)(2) [ ]

I Check applicable boxes: (1) [X] Final K-1 (2) [ ] Amended K-1

J **Analysis of partner's capital account:**

(a) Capital account at beginning of year	(b) Capital contributed during year	(c) Partner's share of lines 3, 4, and 7, Form 1065, Schedule M-2	(d) Withdrawals and distributions	(e) Capital account at end of year (combine columns (a) through (d))
			( )	

	(a) Distributive share item		(b) Amount	(c) 1040 filers enter the amount in column (b) on
Income (Loss)	1 Ordinary income (loss) from trade or business activities	1	45,000.	See page 6 of Partner's Instructions for Schedule K-1 (Form 1065)
	2 Net income (loss) from rental real estate activities	2		
	3 Net income (loss) from other rental activities	3		
	4 Portfolio income (loss):			
	a Interest	4a		Sch. B, Part I, line 1
	b Ordinary dividends	4b		Sch. B, Part II, line 5
	c Royalties	4c		Sch. E, Part I, line 4
	d Net short-term capital gain (loss)	4d		Sch. D, line 5, col. (f)
	e Net long-term capital gain (loss):			
	(1) 28% rate gain (loss)	e(1)		Sch. D, line 12, col. (g)
	(2) Total for year	e(2)		Sch. D, line 12, col. (f)
	f Other portfolio income (loss) (attach schedule)	4f		Enter on applicable line of your return
	5 Guaranteed payments to partner	5		See page 6 of Partner's Instructions for Schedule K-1 (Form 1065)
	6 Net section 1231 gain (loss) (other than due to casualty or theft)	6		
	7 Other income (loss) (attach schedule)	7		Enter on applicable line of your return
Deductions	8 Charitable contributions (see instructions) (attach schedule)	8		Sch. A, line 15 or 16
	9 Section 179 expense deduction	9		
	10 Deductions related to portfolio income (attach schedule)	10		See pages 7 and 8 of Partner's Instructions for Schedule K-1 (Form 1065)
	11 Other deductions (attach schedule)	11		
	12a Low-income housing credit:			
	(1) From section 42(j)(5) partnerships for property placed in service before 1990	a(1)		Form 8586, line 5
	(2) Other than on line 12a(1) for property placed in service before 1990	a(2)		
	(3) From section 42(j)(5) partnerships for property placed in service after 1989	a(3)		
	(4) Other than on line 12a(3) for property placed in service after 1989	a(4)		
	b Qualified rehabilitation expenditures related to rental real estate activities	12b		See page 8 of Partner's Instructions for Schedule K-1 (Form 1065)
	c Credits (other than credits shown on lines 12a and 12b) related to rental real estate activities	12c		
	d Credits related to other rental activities	12d		
	13 Other credits	13		

	(a) Distributive share item		(b) Amount	(c) 1040 filers enter the amount in column (b) on:
Investment Interest	14 a Interest expense on investment debts	14a		Form 4952, line 1 See page 9 of Partner's Instructions for Schedule K-1 (Form 1065)
	b (1) Investment income included on lines 4a, 4b, 4c, and 4f	b(1)		
	(2) Investment expenses included on line 10	b(2)		
Self-employment	15 a Net earnings (loss) from self-employment	15a		Sch. SE, Section A or B See page 9 of Partner's Instructions for Schedule K-1 (Form 1065)
	b Gross farming or fishing income	15b		
	c Gross nonfarm income	15c		
Adjustments and Tax Preference Items	16 a Depreciation adjustment on property placed in service after 1986	16a		See page 9 of Partner's Instructions for Schedule K-1 (Form 1065) and Instructions for Form 6251
	b Adjusted gain or loss	16b		
	c Depletion (other than oil and gas)	16c		
	d (1) Gross income from oil, gas, and geothermal properties	d(1)		
	(2) Deductions allocable to oil, gas, and geothermal properties	d(2)		
	e Other adjustments and tax preference items (attach schedule)	16e		
Foreign Taxes	17 a Type of income ▶			Form 1116, check boxes
	b Name of foreign country or possession ▶			Form 1116, Part I
	c Total gross income from sources outside the United States (attach schedule)	17c		
	d Total applicable deductions and losses (attach schedule)	17d		
	e Total foreign taxes (check one) ▶ ☐ Paid ☐ Accrued	17e		Form 1116, Part II Form 1116, Part III
	f Reduction in taxes available for credit (attach schedule)	17f		
	g Other foreign tax information (attach schedule)	17g		See Instructions for Form 1116
Other	18 Section 59(e)(2) expenditures a Type ▶			See page 9 of Partner's Instructions for Schedule K-1 (Form 1065)
	b Amount	18b		
	19 Tax-exempt interest income SEE STATEMENT 1.	19	862.	Form 1040, line 8b
	20 Other tax-exempt income	20		See pages 9 and 10 of Partner's Instructions for Schedule K-1 (Form 1065)
	21 Nondeductible expenses	21		
	22 Distributions of money (cash and marketable securities)	22		
	23 Distributions of property other than money	23		
	24 Recapture of low-income housing credit			
	a From section 42(j)(5) partnerships	24a		Form 8611, line 8
	b Other than on line 24a	24b		

Supplemental Information

25 Supplemental information required to be reported separately to each partner (attach additional schedules if more space is needed)

LINE 19 - TAX-EXEMPT INTEREST INCOME

TAX EXEMPT MONEY MARKET	862.
TOTAL TAX-EXEMPT INTEREST INCOME	862.

Department of the Treasury
Internal Revenue Service

Date October 1, 2007

CERTIFICATE OF OFFICIAL RECORD

I certify that the annexed: is a and complete copy of the U. S. Income Tax Return of Income (Form 1065) for Tesoro Drive Partners, EIN: 74-2936193, 9000 Tesoro Drive, Suite 122, San Antonio, Texas 78217, for calendar year beginning November 18, 1999 and ending December 27, 1999, which was received in the regular course of business of the Internal Revenue Service and consists of fourteen (14) pages

under the custody of this office.

IN WITNESS WHEREOF, I have hereunto set my hand, and caused the seal of this office to be affixed, on the day and year first above written.

By direction of the Secretary of the Treasury:

Thomas D. Mathews
Director Advisory, Insolvency & Quality
Small Business Self Employed Division

Felix J. Carrillo Jr.
Technical Services Group Manager, Houston
Small Business Self Employed Division

Form 2866

250

DEFENDANT'S EXHIBIT 250

10260099238818-0

SHORT YEAR FINAL INITIAL RETURN

Form **1065**

Department of the Treasury
Internal Revenue Service

U.S. Partnership Return of Income

For calendar year 1999, or tax year beginning 11/18, 1999, and ending 12/27, 1999

▶ See separate instructions.

OMB No. 1545-0099

1999

A Principal business activity: **INVESTMENT**

B Principal product or service: **INVESTMENT**

C Business code number: **523900**

Name of partnership: **TESORO DRIVE PARTNERS**

Number, street, and room or suite no. (If a P.O. box, see page 12 of the instructions.): **9000 TESORO DRIVE, SUITE 122**

City or town, state, and ZIP code: **SAN ANTONIO TX 78217**

D Employer identification number: **74-2936193**

E Date business started: **11/18/1999**

F Total assets (see page 12 of the instructions): $

G Check applicable boxes: (1) [X] Initial return (2) [X] Final return (3) [ ] Change in address (4) [ ] Amended return

H Check accounting method: (1) [X] Cash (2) [ ] Accrual (3) [ ] Other (specify) ▶

I Number of Schedules K-1. Attach one for each person who was a partner at any time during the tax year ▶ **2**

Caution: *Include only trade or business income and expenses on lines 1a through 22 below. See the instructions for more information.*

Income	1a Gross receipts or sales	1a		
	b Less returns and allowances	1b		1c
	2 Cost of goods sold (Schedule A, line 8)			2
	3 Gross profit. Subtract line 2 from line 1c			3
	4 Ordinary income (loss) from other partnerships, estates, and trusts (*attach schedule*)			4
	5 Net farm profit (loss) (*attach Schedule F (Form 1040)*)			5
	6 Net gain (loss) from Form 4797, Part II, line 18			6 650,000.
	7 Other income (loss) (*attach schedule*)			7
	8 Total income (loss). Combine lines 3 through 7			8 650,000.
Deductions (see the instructions for limitations)	9 Salaries and wages (other than to partners) (less employment credits)			9
	10 Guaranteed payments to partners			10
	11 Repairs and maintenance			11
	12 Bad debts			12
	13 Rent			13
	14 Taxes and licenses			14
	15 Interest			15
	16 a Depreciation (if required, attach Form 4562)	16a		
	b Less depreciation reported on Schedule A and elsewhere on return	16b		16c
	17 Depletion (Do not deduct oil and gas depletion.)			17
	18 Retirement plans, etc.			18
	19 Employee benefit programs			19
	20 Other deductions (*attach schedule*)			20
	21 **Total deductions.** Add the amounts shown in the far right column for lines 9 through 20			21
	22 **Ordinary income (loss)** from trade or business activities. Subtract line 21 from line 8			22 650,000.

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IRS AUSC
AUSTIN, TEXAS

Under penalties of perjury, I declare that I have examined this return, including accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete. Declaration of preparer (other than general partner or limited liability company member) is based on all information of which preparer has any knowledge.

Please Sign Here — Signature of general partner or limited liability company member ▶ — Date ▶ 3-27-00

Paid Preparer's Use Only

Preparer's signature ▶ Stewart Gordon, CPA — Date 3/20/00 — Check if self-employed ▶ [ ] — Preparer's SSN or PTIN P00054462

Firm's name (or yours if self-employed) and address ▶ ERNST & YOUNG LLP, 1150 18TH STREET NW, SUITE 500, WASHINGTON, DC — EIN ▶ 34-6565596 — ZIP code ▶ 20036-0000

Schedule A **Cost of Goods Sold** (see page 17 of the instructions)

1	Inventory at beginning of year	1	
2	Purchases less cost of items withdrawn for personal use	2	
3	Cost of labor	3	
4	Additional section 263A costs (attach schedule)	4	
5	Other costs (attach schedule)	5	
6	**Total.** Add lines 1 through 5	6	
7	Inventory at end of year	7	
8	**Cost of goods sold.** Subtract line 7 from line 6. Enter here and on page 1, line 2	8	

9 a Check all methods used for valuing closing inventory
- (i) ☐ Cost as described in Regulations section 1.471-3
- (ii) ☐ Lower of cost or market as described in Regulations section 1.471-4
- (iii) ☐ Other (specify method used and attach explanation) ▶

b Check this box if there was a writedown of "subnormal" goods as described in Regulations section 1.471-2(c) ▶ ☐

c Check this box if the LIFO inventory method was adopted this tax year for any goods (if checked, attach Form 970) ▶ ☐

d Do the rules of section 263A (for property produced or acquired for resale) apply to the partnership? ☐ Yes ☐ No

e Was there any change in determining quantities, cost, or valuations between opening and closing inventory? ☐ Yes ☐ No
If "Yes," attach explanation

Schedule B **Other Information**

		Yes	No
1	What type of entity is filing this return? Check the applicable box		
	a ☒ General partnership b ☐ Limited partnership c ☐ Limited liability company		
	d ☐ Limited liability partnership e ☐ Other ▶		
2	Are any partners in this partnership also partnerships?		X
3	Is this partnership a partner in another partnership?		X
4	Is this partnership subject to the consolidated audit procedures of sections 6221 through 6233? If "Yes," see **Designation of Tax Matters Partner** below		X
5	Does this partnership meet **ALL THREE** of the following requirements?		
a	The partnership's total receipts for the tax year were less than $250,000.		
b	The partnership's total assets at the end of the tax year were less than $600,000. **AND**		
c	Schedules K-1 are filed with the return and furnished to the partners on or before the due date (including extensions) for the partnership return. If "Yes," the partnership is not required to complete Schedules L, M-1, and M-2, Item F on page 1 of Form 1065, or Item J on Schedule K-1.	X	
6	Does this partnership have any foreign partners?		X
7	Is this partnership a publicly traded partnership as defined in section 469(k)(2)?		X
8	Has this partnership filed, or is it required to file, Form **8264**, Application for Registration of a Tax Shelter?		X
9	At any time during calendar year 1999, did the partnership have an interest in or a signature or other authority over a financial account in a foreign country (such as a bank account, securities account, or other financial account)? See page 18 of the instructions for exceptions and filing requirements for Form TD F 90-22.1. If "Yes," enter the name of the foreign country ▶		X
10	During the tax year, did the partnership receive a distribution from, or was it the grantor of, or transferor to, a foreign trust? If "Yes," the partnership may have to file Form 3520. See page 18 of the instructions.		X
11	Was there a distribution of property or a transfer (e.g., by sale or death) of a partnership interest during the tax year? If "Yes," you may elect to adjust the basis of the partnership's assets under section 754 by attaching the statement described under **Elections Made By the Partnership** on page 7 of the instructions.	X	

Designation of Tax Matters Partner (see page 18 of the instructions)

Enter below the general partner designated as the tax matters partner (TMP) for the tax year of this return:

Name of designated TMP ▶ _____ Identifying number of TMP ▶ _____

Address of designated TMP ▶ _____

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Form 1065 (1999) TESORO DRIVE PARTNERS 74-2936193 Page 3

Schedule K Partners' Shares of Income, Credits, Deductions, etc.

			(a) Distributive share items		(b) Total amount
Income (Loss)	1		Ordinary income (loss) from trade or business activities (page 1, line 22)	1	650,000.
	2		Net income (loss) from rental real estate activities (attach Form 8825)	2	
	3a		Gross income from other rental activities — 3a		
		b	Expenses from other rental activities (attach schedule) — 3b		
		c	Net income (loss) from other rental activities. Subtract line 3b from line 3a	3c	
	4		Portfolio income (loss):		
		a	Interest income	4a	
		b	Ordinary dividends	4b	
		c	Royalty income	4c	
		d	Net short-term capital gain (loss) (attach Schedule D (Form 1065)) STMT 1	4d	5,037.
		e	Net long-term capital gain (loss) (attach Schedule D (Form 1065)): (1) 28% rate gain (loss) ▶ (2) Total for year ▶	4e(2)	
		f	Other portfolio income (loss) (attach schedule)	4f	
	5		Guaranteed payments to partners	5	
	6		Net section 1231 gain (loss) (other than due to casualty or theft) (attach Form 4797)	6	
	7		Other income (loss) (attach schedule)	7	
Deductions	8		Charitable contributions (attach schedule)	8	
	9		Section 179 expense deduction (attach Form 4562)	9	
	10		Deductions related to portfolio income (itemize)	10	
	11		Other deductions (attach schedule)	11	
Credits	12a		Low-income housing credit:		
		(1)	From partnerships to which section 42(j)(5) applies for property placed in service before 1990	12a(1)	
		(2)	Other than on line 12a(1) for property placed in service before 1990	12a(2)	
		(3)	From partnerships to which section 42(j)(5) applies for property placed in service after 1989	12a(3)	
		(4)	Other than on line 12a(3) for property placed in service after 1989	12a(4)	
		b	Qualified rehabilitation expenditures related to rental real estate activities (attach Form 3468)	12b	
		c	Credits (other than credits shown on lines 12a and 12b) related to rental real estate activities	12c	
		d	Credits related to other rental activities	12d	
	13		Other credits	13	
Investment Interest	14a		Interest expense on investment debts	14a	
		b	(1) Investment income included on lines 4a, 4b, 4c, and 4f above	14b(1)	
			(2) Investment expenses included on line 10 above	14b(2)	
Self-Employment	15a		Net earnings (loss) from self-employment	15a	
		b	Gross farming or fishing income	15b	
		c	Gross nonfarm income	15c	
Adjustments and Tax Preference Items	16a		Depreciation adjustment on property placed in service after 1986	16a	
		b	Adjusted gain or loss	16b	
		c	Depletion (other than oil and gas)	16c	
		d	(1) Gross income from oil, gas, and geothermal properties	16d(1)	
			(2) Deductions allocable to oil, gas, and geothermal properties	16d(2)	
		e	Other adjustments and tax preference items (attach schedule)	16e	
Foreign Taxes	17a		Type of income ▶		
		b	Name of foreign country or U.S. possession ▶		
		c	Total gross income from sources outside the United States (attach schedule)	17c	
		d	Total applicable deductions and losses (attach schedule)	17d	
		e	Total foreign taxes (check one): ▶ ☐ Paid ☐ Accrued	17e	
		f	Reduction in taxes available for credit (attach schedule)	17f	
		g	Other foreign tax information (attach schedule)	17g	
Other	18		Section 59(e)(2) expenditures: a Type ▶ b Amount ▶	18b	
	19		Tax-exempt interest income SEE STATEMENT 1	19	764.
	20		Other tax-exempt income	20	
	21		Nondeductible expenses	21	
	22		Distributions of money (cash and marketable securities)	22	
	23		Distributions of property other than money	23	
	24		Other items and amounts required to be reported separately to partners (attach schedule)		

Form 1065 (1999)

Analysis of Net Income (Loss)

1 Net income (loss). Combine Schedule K, lines 1 through 7 in column (b). From the result, subtract the sum of Schedule K, lines 8 through 11, 14a, 17e, and 18b					1	655,037.
2 Analysis by partner type	(i) Corporate	(ii) Individual (active)	(iii) Individual (passive)	(iv) Partnership	(v) Exempt organization	(vi) Nominee/Other
a General partners		655,037.				
b Limited partners						

Schedule L Balance Sheets per Books (Not required if Question 5 on Schedule B is answered "Yes.")

Assets	Beginning of tax year (a)	Beginning of tax year (b)	End of tax year (c)	End of tax year (d)
1 Cash				
2a Trade notes and accounts receivable				
b Less allowance for bad debts				
3 Inventories				
4 U.S. government obligations				
5 Tax-exempt securities				
6 Other current assets (attach schedule)				
7 Mortgage and real estate loans				
8 Other investments (attach schedule)				
9a Buildings and other depreciable assets				
b Less accumulated depreciation				
10a Depletable assets				
b Less accumulated depletion				
11 Land (net of any amortization)				
12a Intangible assets (amortizable only)				
b Less accumulated amortization				
13 Other assets (attach schedule)				
14 Total assets				
Liabilities and Capital				
15 Accounts payable				
16 Mortgages, notes, bonds payable in less than 1 year				
17 Other current liabilities (attach schedule)				
18 All nonrecourse loans				
19 Mortgages, notes, bonds payable in 1 year or more				
20 Other liabilities (attach schedule)				
21 Partners' capital accounts				
22 Total liabilities and capital				

Schedule M-1 Reconciliation of Income (Loss) per Books With Income (Loss) per Return

(Not required if Question 5 on Schedule B is answered "Yes." See page 29 of the instructions.)

1 Net income (loss) per books		6 Income recorded on books this year not included on Schedule K, lines 1 through 7 (itemize): a Tax-exempt interest $	
2 Income included on Schedule K, lines 1 through 4, 6, and 7, not recorded on books this year (itemize)			
3 Guaranteed payments (other than health insurance)		7 Deductions included on Schedule K, lines 1 through 11, 14a, 17e, and 18b, not charged against book income this year (itemize): a Depreciation $	
4 Expenses recorded on books this year not included on Schedule K, lines 1 through 11, 14a, 17e, and 18b (itemize): a Depreciation $ b Travel and entertainment $			
5 Add lines 1 through 4		8 Add lines 6 and 7	
		9 Income (loss) (Analysis of Net Income (Loss), line 1). Subtract line 8 from line 5	

Schedule M-2 Analysis of Partners' Capital Accounts (Not required if Question 5 on Schedule B is answered "Yes.")

1 Balance at beginning of year		6 Distributions a Cash	
2 Capital contributed during year		b Property	
3 Net income (loss) per books		7 Other decreases (itemize):	
4 Other increases (itemize):			
5 Add lines 1 through 4		8 Add lines 6 and 7	
		9 Balance at end of year. Subtract line 8 from line 5	

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SCHEDULE D (Form 1065)

Department of the Treasury
Internal Revenue Service

Capital Gains and Losses

▶ Attach to Form 1065.

OMB No. 1545-0099

1999

Name of partnership

TESORO DRIVE PARTNERS

Employer identification number

74-2936193

Part I Short-Term Capital Gains and Losses - Assets Held 1 Year or Less

(a) Description of property (e.g., 100 shares of "Z" Co.)	(b) Date acquired (month, day, year)	(c) Date sold (month, day, year)	(d) Sales price (see instructions)	(e) Cost or other basis (see instructions)	(f) Gain or (loss) ((d) minus (e))
1					
1500 SUN MICROSYSTEMS INC.	12/08/1999	12/20/1999	215,990.	210,953.	5,037.

2 Short-term capital gain from installment sales from Form 6252, line 26 or 37	2	
3 Short-term capital gain (loss) from like-kind exchanges from Form 8824	3	
4 Partnership's share of net short-term capital gain (loss), including specially allocated short-term capital gains (losses), from other partnerships, estates, and trusts	4	
5 **Net short-term capital gain or (loss).** Combine lines 1 through 4 in column (f). Enter here and on Form 1065, Schedule K, line 4d or 7	5	5,037.

Part II Long-Term Capital Gains and Losses - Assets Held More Than 1 Year

(a) Description of property (e.g., 100 shares of "Z" Co.)	(b) Date acquired (month, day, year)	(c) Date sold (month, day, year)	(d) Sales price (see instructions)	(e) Cost or other basis (see instructions)	(f) Gain or (loss) ((d) minus (e))	(g) 28% rate gain or (loss) *(see instr. below)
6						

7 Long-term capital gain from installment sales from Form 6252, line 26 or 37	7	
8 Long-term capital gain (loss) from like-kind exchanges from Form 8824	8	
9 Partnership's share of net long-term capital gain (loss), including specially allocated long-term capital gains (losses), from other partnerships, estates, and trusts	9	
10 Capital gain distributions	10	
11 Combine lines 6 through 10 in column (g). Enter here and on Form 1065, Schedule K, line 4e(1) or 7	11	
12 **Net long-term capital gain or (loss).** Combine lines 6 through 10 in column (f). Enter here and on Form 1065, Schedule K, line 4e(2) or 7	12	

*28% rate gain or (loss) includes all "collectibles gains and losses" as defined in the instructions.

Form **4797**

Department of the Treasury
Internal Revenue Service (99)

Sales of Business Property
(Also Involuntary Conversions and Recapture Amounts Under Sections 179 and 280F(b)(2))

▶ Attach to your tax return. ▶ See separate instructions.

OMB No. 1545-0184

1999

Attachment Sequence No. **27**

Name(s) shown on return

Identifying number

TESORO DRIVE PARTNERS

74-2936193

1 Enter here the gross proceeds from the sale or exchange of real estate reported to you for 1999 on Form(s) 1099-S (or a substitute statement) that you will be including on line 2, 10, or 20 1

Part I Sales or Exchanges of Property Used in a Trade or Business and Involuntary Conversions From Other Than Casualty or Theft - Property Held More Than 1 Year

	(a) Description of property	(b) Date acquired (mo., day, yr.)	(c) Date sold (mo., day, yr.)	(d) Gross sales price	(e) Depreciation allowed or allowable since acquisition	(f) Cost or other basis, plus improvements and expense of sale	(g) GAIN or (LOSS) Subtract (f) from the sum of (d) and (e)
2							

3	Gain, if any, from Form 4684, line 39	3	
4	Section 1231 gain from installment sales from Form 6252, line 26 or 37	4	
5	Section 1231 gain or (loss) from like-kind exchanges from Form 8824	5	
6	Gain, if any, from line 32, from other than casualty or theft	6	
7	Combine lines 2 through 6. Enter gain or (loss) here and on the appropriate line as follows:	7	

Partnerships (except electing large partnerships). Report the gain or (loss) following the instructions for Form 1065, Schedule K, line 6. Skip lines 8, 9, 11, and 12 below.

S corporations. Report the gain or (loss) following the instructions for Form 1120S, Schedule K, lines 5 and 6. Skip lines 8, 9, 11, and 12 below, unless line 7 is a gain and the S corporation is subject to the capital gains tax.

All others. If line 7 is zero or a loss, enter the amount from line 7 on line 11 below and skip lines 8 and 9. If line 7 is a gain and you did not have any prior year section 1231 losses, or they were recaptured in an earlier year, enter the gain from line 7 as a long-term capital gain on Schedule D and skip lines 8, 9, and 12 below.

8	Nonrecaptured net section 1231 losses from prior years (see instructions)	8	
9	Subtract line 8 from line 7. If zero or less, enter -0-. Also enter on the appropriate line as follows (see instructions)	9	

S corporations. Enter any gain from line 9 on Schedule D (Form 1120S), line 14, and skip lines 11 and 12 below.

All others. If line 9 is zero, enter the gain from line 7 on line 12 below. If line 9 is more than zero, enter the amount from line 8 on line 12 below, and enter the gain from line 9 as a long-term capital gain on Schedule D.

Part II Ordinary Gains and Losses

10 Ordinary gains and losses not included on lines 11 through 17 (include property held 1 year or less):

SEE STATEMENT 2		650,000.

11	Loss, if any, from line 7	11	( )
12	Gain, if any, from line 7 or amount from line 8, if applicable	12	
13	Gain, if any, from line 31	13	
14	Net gain or (loss) from Form 4684, lines 31 and 38a	14	
15	Ordinary gain from installment sales from Form 6252, line 25 or 36	15	
16	Ordinary gain or (loss) from like-kind exchanges from Form 8824	16	
17	Recapture of section 179 expense deduction for partners and S corporation shareholders from property dispositions by partnerships and S corporations (see instructions)	17	
18	Combine lines 10 through 17. Enter the gain or (loss) here, and on the appropriate line as follows:	18	650,000.
a	For all except individual returns: Enter the gain or (loss) from line 18 on the return being filed.		
b	For individual returns:		
(1)	If the loss on line 11 includes a loss from Form 4684, line 35, column (b)(ii), enter that part of the loss here. Enter the part of the loss from income-producing property on Schedule A (Form 1040), line 27, and the part of the loss from property used as an employee on Schedule A (Form 1040), line 22. Identify as from "Form 4797, line 18b(1)." See instructions	18b(1)	
(2)	Redetermine the gain or (loss) on line 18, excluding the loss, if any, on line 18b(1). Enter here and on Form 1040, line 14	18b(2)	

For Paperwork Reduction Act Notice, see separate instructions.

Form **4797** (1999)

Part III Gain From Disposition of Property Under Sections 1245, 1250, 1252, 1254, and 1255

19 (a) Description of section 1245, 1250, 1252, 1254, or 1255 property	(b) Date acquired (mo., day, yr.)	(c) Date sold (mo., day, yr.)
A		
B		
C		
D		

These columns relate to the properties on lines 19A through 19D ▶		Property A	Property B	Property C	Property D
20 Gross sales price (Note: See line 1 before completing.)	20				
21 Cost or other basis plus expense of sale	21				
22 Depreciation (or depletion) allowed or allowable	22				
23 Adjusted basis. Subtract line 22 from line 21	23				
24 Total gain. Subtract line 23 from line 20	24				
25 If section 1245 property:					
a Depreciation allowed or allowable from line 22	25a				
b Enter the smaller of line 24 or 25a	25b				
26 If section 1250 property: If straight line depreciation was used, enter -0- on line 26g, except for a corporation subject to section 291.					
a Additional depreciation after 1975 (see instructions)	26a				
b Applicable percentage multiplied by the smaller of line 24 or line 26a (see instructions)	26b				
c Subtract line 26a from line 24. If residential rental property or line 24 is not more than line 26a, skip lines 26d and 26e	26c				
d Additional depreciation after 1969 and before 1976	26d				
e Enter the smaller of line 26c or 26d	26e				
f Section 291 amount (corporations only)	26f				
g Add lines 26b, 26e, and 26f	26g				
27 If section 1252 property: Skip this section if you did not dispose of farmland or if this form is being completed for a partnership (other than an electing large partnership).					
a Soil, water, and land clearing expenses	27a				
b Line 27a multiplied by applicable percentage (see instructions)	27b				
c Enter the smaller of line 24 or 27b	27c				
28 If section 1254 property:					
a Intangible drilling and development costs, expenditures for development of mines and other natural deposits, and mining exploration costs (see instructions)	28a				
b Enter the smaller of line 24 or 28a	28b				
29 If section 1255 property:					
a Applicable percentage of payments excluded from income under section 126 (see instructions)	29a				
b Enter the smaller of line 24 or 29a (see instructions)	29b				

Summary of Part III Gains. Complete property columns A through D through line 29b before going to line 30

30 Total gains for all properties. Add property columns A through D, line 24	30	
31 Add property columns A through D, lines 25b, 26g, 27c, 28b, and 29b. Enter here and on line 13	31	
32 Subtract line 31 from line 30. Enter the portion from casualty or theft on Form 4684, line 33. Enter the portion from other than casualty or theft on Form 4797, line 6	32	

Part IV Recapture Amounts Under Sections 179 and 280F(b)(2) When Business Use Drops to 50% or Less See instructions

		(a) Section 179	(b) Section 280F(b)(2)
33 Section 179 expense deduction or depreciation allowable in prior years	33		
34 Recomputed depreciation. See instructions	34		
35 Recapture amount. Subtract line 34 from line 33. See the instructions for where to report	35		

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SCHEDULE K - LINE 4D NET SHORT-TERM CAPITAL GAIN/LOSS

PORTFOLIO ACTIVITIES	5,037.
TOTAL NET SHORT-TERM CAPITAL GAIN/LOSS	5,037

SCHEDULE K - LINE 19 - TAX-EXEMPT INTEREST INCOME

TAX EXEMPT MONEY MARKET	764.
TOTAL TAX-EXEMPT INTEREST INCOME	764.

OTHER ORDINARY GAINS AND LOSSES

DESCRIP. OF PROPERTY	DATE ACQUIRED	DATE SOLD	GROSS SALES PRICE	ALLOWABLE DEPRECIATION	COST/BASIS	LOSS	GAIN
CURRENCY CONTRACT	11/18/99	12/20/99	800,000.		8,000,000.	7,200,000.	
CURRENCY CONTRACT	11/18/99	12/20/99	7,600,000.				7,600,000.
CURRENCY CONTRACT	11/18/99	12/20/99	500,000.		5,000,000.	4,500,000.	
CURRENCY CONTRACT	11/18/99	12/20/99	4,750,000.				4,750,000.
TOTAL OTHER ORDINARY GAINS AND LOSSES						11,700,000.	12,350,000.

Partner Summary

Partner Number	Partner Name	Partner I D Number	Beginning Profit Ratio	Beginning Loss Ratio	Beginning Ownership Ratio	Beginning Capital	Capital Contributions	Cash Distributions	Property Distributions
1	GW TESORO IRV, LLC	74-2936194	0.6154000000000	0.6154000000000	0.6154000000000				
2	RJW TESORO DRIVE IRV	74-2936195	0.3846000000000	0.3846000000000	0.3846000000000				
Totals			1.0000000000000	1.0000000000000	1.0000000000000				

SHORT YEAR FINAL INITIAL

SCHEDULE K-1 (Form 1065) — Department of the Treasury, Internal Revenue Service

Partner's Share of Income, Credits, Deductions, etc.

▶ See separate instructions

For calendar year 1999 or tax year beginning 11/18, 1999, and ending 12/27/1999

OMB No. 1545-0099

1999

Partner's identifying number ▶ 74-2936194	Partnership's identifying number ▶ 74-2936193
Partner's name, address, and ZIP code PARTNER # 1 GW TESORO INV. LLC 9000 TESORO DRIVE, SUITE 122 SUITE 122 SAN ANTONIO, TX 78217	Partnership's name, address, and ZIP code TESORO DRIVE PARTNERS 9000 TESORO DRIVE, SUITE 122 SAN ANTONIO, TX 78217

A This partner is a [X] general partner [ ] limited partner [ ] limited liability company member

B What type of entity is this partner? ▶ LIMITED LIAB CO

C Is this partner a [X] domestic or a [ ] foreign partner?

D Enter partner's percentage of

	(i) Before change or termination	(ii) End of year
Profit sharing	61.540000 % NONE	%
Loss sharing	61.540000 % NONE	%
Ownership of capital	61.540000 % NONE	%

E IRS Center where partnership filed return: AUSTIN, TX 73301-0011

F Partner's share of liabilities (see instructions)
Nonrecourse
Qualified nonrecourse financing
Other

G Tax shelter registration number ▶

H Check here if this partnership is a publicly traded partnership as defined in section 469(k)(2) [ ]

I Check applicable boxes (1) [X] Final K-1 (2) [ ] Amended K-1

J Analysis of partner's capital account:

(a) Capital account at beginning of year	(b) Capital contributed during year	(c) Partner's share of lines 3, 4, and 7, Form 1065, Schedule M-2	(d) Withdrawals and distributions	(e) Capital account at end of year (combine columns (a) through (d))
			( )	

	(a) Distributive share item		(b) Amount	(c) 1040 filers enter the amount in column (b) on
Income (Loss)	1 Ordinary income (loss) from trade or business activities	1	400,010.	See page 6 of Partner's Instructions for Schedule K-1 (Form 1065)
	2 Net income (loss) from rental real estate activities	2		
	3 Net income (loss) from other rental activities	3		
	4 Portfolio income (loss):			
	a Interest	4a		Sch. B, Part I, line 1
	b Ordinary dividends	4b		Sch. B, Part II, line 5
	c Royalties	4c		Sch. E, Part I, line 4
	d Net short-term capital gain (loss)	4d	3,100.	Sch. D, line 5, col. (f)
	e Net long-term capital gain (loss):			
	(1) 28% rate gain (loss)	*(1)		Sch. D, line 12, col. (g)
	(2) Total for year	*(2)		Sch. D, line 12, col. (f)
	f Other portfolio income (loss) *(attach schedule)*	4f		Enter on applicable line of your return
	5 Guaranteed payments to partner	5		See page 6 of Partner's Instructions for Schedule K-1 (Form 1065)
	6 Net section 1231 gain (loss) (other than due to casualty or theft)	6		
	7 Other income (loss) *(attach schedule)*	7		Enter on applicable line of your return
Deductions	8 Charitable contributions (see instructions) *(attach schedule)*	8		Sch. A, line 15 or 16
	9 Section 179 expense deduction	9		
	10 Deductions related to portfolio income *(attach schedule)*	10		See pages 7 and 8 of Partner's Instructions for Schedule K-1 (Form 1065)
	11 Other deductions *(attach schedule)*	11		
Credits	12a Low-income housing credit:			
	(1) From section 42(j)(5) partnerships for property placed in service before 1990	a(1)		Form 8586, line 5
	(2) Other than on line 12a(1) for property placed in service before 1990	a(2)		
	(3) From section 42(j)(5) partnerships for property placed in service after 1989	a(3)		
	(4) Other than on line 12a(3) for property placed in service after 1989	a(4)		
	b Qualified rehabilitation expenditures related to rental real estate activities	12b		See page 8 of Partner's Instructions for Schedule K-1 (Form 1065)
	c Credits (other than credits shown on lines 12a and 12b) related to rental real estate activities	12c		
	d Credits related to other rental activities	12d		
	13 Other credits	13		

For Paperwork Reduction Act Notice, see Instructions for Form 1065 — Schedule K-1 (Form 1065) 1999

	(a) Distributive share item		(b) Amount	(c) 1040 filers enter the amount in column (b) on:
Investment Interest	14 a Interest expense on investment debts	14a		Form 4952, line 1 See page 9 of Partner's Instructions for Schedule K-1 (Form 1065)
	b (1) Investment income included on lines 4a, 4b, 4c, and 4f	b(1)		
	(2) Investment expenses included on line 10	b(2)		
Self-Employment	15 a Net earnings (loss) from self-employment	15a		Sch SE, Section A or B See page 9 of Partner's Instructions for Schedule K-1 (Form 1065)
	b Gross farming or fishing income	15b		
	c Gross nonfarm income	15c		
Adjustments and Tax Preference Items	16 a Depreciation adjustment on property placed in service after 1986	16a		See page 9 of Partner's Instructions for Schedule K-1 (Form 1065) and Instructions for Form 6251
	b Adjusted gain or loss	16b		
	c Depletion (other than oil and gas)	16c		
	d (1) Gross income from oil, gas, and geothermal properties	d(1)		
	(2) Deductions allocable to oil, gas, and geothermal properties	d(2)		
	e Other adjustments and tax preference items (attach schedule)	16e		
Foreign Taxes	17 a Type of income ▶	17a		Form 1116, check boxes
	b Name of foreign country or possession ▶	17b		
	c Total gross income from sources outside the United States (attach schedule)	17c		Form 1116, Part I
	d Total applicable deductions and losses (attach schedule)	17d		
	e Total foreign taxes (check one) ▶ ☐ Paid ☐ Accrued	17e		Form 1116, Part II
	f Reduction in taxes available for credit (attach schedule)	17f		Form 1116, Part III
	g Other foreign tax information (attach schedule)	17g		See Instructions for Form 1116
Other	18 Section 59(e)(2) expenditures a Type ▶	18a		See page 9 of Partner's Instructions for Schedule K-1 (Form 1065)
	b Amount	18b		
	19 Tax-exempt interest income	19	470.	Form 1040, line 8b
	20 Other tax-exempt income	20		See pages 9 and 10 of Partner's Instructions for Schedule K-1 (Form 1065)
	21 Nondeductible expenses	21		
	22 Distributions of money (cash and marketable securities)	22		
	23 Distributions of property other than money	23		
	24 Recapture of low-income housing credit			
	a From section 42(j)(5) partnerships	24a		Form 8611, line 8
	b Other than on line 24a	24b		

Supplemental Information

25 Supplemental information required to be reported separately to each partner (attach additional schedules if more space is needed)

1859

SHORT YEAR FINAL INITIAL

SCHEDULE K-1 (Form 1065) — Department of the Treasury, Internal Revenue Service

Partner's Share of Income, Credits, Deductions, etc.

▶ See separate instructions

For calendar year 1999 or tax year beginning 11/18, 1999, and ending 12/27/1999

OMB No. 1545-0099

1999

Partner's identifying number ▶ 74-2936195	Partnership's identifying number ▶ 74-2936193
Partner's name, address, and ZIP code PARTNER # 2 BJM TESORO DRIVE INV. 9000 TESORO DRIVE, SUITE 122 SUITE 122 SAN ANTONIO, TX 78217	Partnership's name, address, and ZIP code TESORO DRIVE PARTNERS 9000 TESORO DRIVE, SUITE 122 SAN ANTONIO, TX 78217

A This partner is a [X] general partner [ ] limited partner
[ ] limited liability company member

B What type of entity is this partner? ▶ LIMITED LIAB CO

C Is this partner a [X] domestic or a [ ] foreign partner?

D Enter partner's percentage of:

	(i) Before change or termination	(ii) End of year
Profit sharing	38.460000 %NONE	%
Loss sharing	38.460000 %NONE	%
Ownership of capital	38.460000 %NONE	%

E IRS Center where partnership filed return
AUSTIN, TX 73301-0011

F Partner's share of liabilities (see instructions)
Nonrecourse
Qualified nonrecourse financing
Other

G Tax shelter registration number ▶

H Check here if this partnership is a publicly traded partnership as defined in section 469(k)(2) [ ]

I Check applicable boxes: (1) [X] Final K-1 (2) [ ] Amended K-1

J **Analysis of partner's capital account:**

(a) Capital account at beginning of year	(b) Capital contributed during year	(c) Partner's share of lines 3, 4, and 7, Form 1065, Schedule M-2	(d) Withdrawals and distributions	(e) Capital account at end of year (combine columns (a) through (d))
			( )	

	(a) Distributive share item		(b) Amount	(c) 1040 filers enter the amount in column (b) on
Income (Loss)	1 Ordinary income (loss) from trade or business activities	1	249,990.	See page 5 of Partner's Instructions for Schedule K-1 (Form 1065)
	2 Net income (loss) from rental real estate activities	2		
	3 Net income (loss) from other rental activities	3		
	4 Portfolio income (loss)			
	a Interest	4a		Sch. B, Part I, line 1
	b Ordinary dividends	4b		Sch. B, Part II, line 5
	c Royalties	4c		Sch. E, Part I, line 4
	d Net short-term capital gain (loss)	4d	1,937.	Sch. D, line 5, col. (f)
	e Net long-term capital gain (loss)			
	(1) 28% rate gain (loss)	e(1)		Sch. D, line 12, col. (g)
	(2) Total for year	e(2)		Sch. D, line 12, col. (f)
	f Other portfolio income (loss) (attach schedule)	4f		Enter on applicable line of your return
	5 Guaranteed payments to partner	5		See page 6 of Partner's Instructions for Schedule K-1 (Form 1065)
	6 Net section 1231 gain (loss) (other than due to casualty or theft)	6		
	7 Other income (loss) (attach schedule)	7		Enter on applicable line of your return
Deductions	8 Charitable contributions (see instructions) (attach schedule)	8		Sch. A, line 15 or 16
	9 Section 179 expense deduction	9		
	10 Deductions related to portfolio income (attach schedule)	10		See pages 7 and 8 of Partner's Instructions for Schedule K-1 (Form 1065)
	11 Other deductions (attach schedule)	11		
Credits	12a Low-income housing credit			
	(1) From section 42(j)(5) partnerships for property placed in service before 1990	a(1)		Form 8586, line 5
	(2) Other than on line 12a(1) for property placed in service before 1990	a(2)		
	(3) From section 42(j)(5) partnerships for property placed in service after 1989	a(3)		
	(4) Other than on line 12a(3) for property placed in service after 1989	a(4)		
	b Qualified rehabilitation expenditures related to rental real estate activities	12b		See page 8 of Partner's Instructions for Schedule K-1 (Form 1065)
	c Credits (other than credits shown on lines 12a and 12b) related to rental real estate activities	12c		
	d Credits related to other rental activities	12d		
	13 Other credits	13		

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Schedule K-1 (Form 1065) 1999

Schedule K-1 (Form 1065) 1999 PARTNER # 2 BJM TESORO DRIVE INV. Page 2

		(a) Distributive share item		(b) Amount	(c) 1040 filers enter the amount in column (b) on:
Investment Interest	14 a	Interest expense on investment debts	14a		Form 4952, line 1 See page 9 of Partner's Instructions for Schedule K-1 (Form 1065)
	b	(1) Investment income included on lines 4a, 4b, 4c, and 4f	b(1)		
		(2) Investment expenses included on line 10	b(2)		
Self-Employment	15 a	Net earnings (loss) from self-employment	15a		Sch. SE, Section A or B See page 9 of Partner's Instructions for Schedule K-1 (Form 1065)
	b	Gross farming or fishing income	15b		
	c	Gross nonfarm income	15c		
Adjustments and Tax Preference Items	16 a	Depreciation adjustment on property placed in service after 1986	16a		See page 9 of Partner's Instructions for Schedule K-1 (Form 1065) and Instructions for Form 6251
	b	Adjusted gain or loss	16b		
	c	Depletion (other than oil and gas)	16c		
	d	(1) Gross income from oil, gas, and geothermal properties	d(1)		
		(2) Deductions allocable to oil, gas, and geothermal properties	d(2)		
	e	Other adjustments and tax preference items (attach schedule)	16e		
Foreign Taxes	17 a	Type of income ▶			Form 1116, check boxes
	b	Name of foreign country or possession ▶			Form 1116, Part I
	c	Total gross income from sources outside the United States (attach schedule)	17c		
	d	Total applicable deductions and losses (attach schedule)	17d		
	e	Total foreign taxes (check one) ▶ ☐ Paid ☐ Accrued	17e		Form 1116, Part II
	f	Reduction in taxes available for credit (attach schedule)	17f		Form 1116, Part III
	g	Other foreign tax information (attach schedule)	17g		See instructions for Form 1116
Other	18	Section 59(e)(2) expenditures a Type ▶			See page 9 of Partner's Instructions for Schedule K-1 (Form 1065)
	b	Amount	18b		
	19	Tax-exempt interest income	19	294.	Form 1040, line 8b
	20	Other tax-exempt income	20		See pages 9 and 10 of Partner's Instructions for Schedule K-1 (Form 1065)
	21	Nondeductible expenses	21		
	22	Distributions of money (cash and marketable securities)	22		
	23	Distributions of property other than money	23		
	24	Recapture of low-income housing credit			
	a	From section 42(j)(5) partnerships	24a		Form 8611, line 8
	b	Other than on line 24a	24b		

Supplemental Information

25 Supplemental information required to be reported separately to each partner (attach additional schedules if more space is needed)

[5]

Department of the Treasury
Internal Revenue Service

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Date October 1, 2007

CERTIFICATE OF OFFICIAL RECORD

I certify that the annexed: is a and complete copy of the U. S. Income Tax Return for an S Corporation, (Form 1120S) for SA Tesoro Drive Investors Inc., EIN: 74-2936189, 9000 Tesoro Drive, Suite 122, San Antonio, Texas 78217, for calendar year beginning November 12, 1999 and ending December 31, 1999, which was received in the regular course of business of the Internal Revenue Service and consists of fourteen (14) pages

under the custody of this office.

IN WITNESS WHEREOF, I have hereunto set my hand, and caused the seal of this office to be affixed, on the day and year first above written.

By direction of the Secretary of the Treasury:

Thomas D. Mathews
Director Advisory, Insolvency & Quality
Small Business Self Employed Division

Felix J. Carrillo Jr.
Technical Services Group Manager, Houston
Small Business Self Employed Division

Form 2866

D0252

DEFENDANT'S EXHIBIT 252

Form **1120S** — Department of the Treasury, Internal Revenue Service

U.S. Income Tax Return for an S Corporation

18346092088 18-0

▶ Do not file this form unless the corporation has timely filed Form 2553 to elect to be an S corporation.
▶ See separate instructions.

OMB No. 1545-0130

1999

For calendar year 1999, or tax year beginning 11/12/1999, and ending 12/31/1999

A If incorporated date of election as an S corporation	Use IRS label. Otherwise, please print or type	Name	C Employer identification number
11/12/1999		SA TESORO DRIVE INVESTORS INC.	74-2936189
B Business code no. (see pages 26-29)		Number, street, and room or suite no. (If a P.O. box, see page 10 of the instructions.)	D Date incorporated
523900		9000 TESORO DRIVE, SUITE 122	11/12/1999
		City or town, state, and ZIP code	E Total assets (see page 10)
		SAN ANTONIO, TX 78217	2,468,172.

F Check applicable boxes: (1) [X] Initial return (2) [ ] Final return (3) [ ] Change in address (4) [ ] Amended return

G Enter number of shareholders in the corporation at end of the tax year ▶ 2

Caution: Include only trade or business income and expenses on lines 1a through 21. See page 10 of the instructions for more information.

Income	1a Gross receipts or sales	b Less returns and allowances	c Bal ▶ 1c	
	2 Cost of goods sold (Schedule A, line 8)		2	
	3 Gross profit. Subtract line 2 from line 1c		3	
	4 Net gain (loss) from Form 4797, Part II, line 18 (attach Form 4797)		4	
	5 Other income (loss) (attach schedule)		5	
	6 Total income (loss). Combine lines 3 through 5		▶ 6	
Deductions (see page 11 of the instructions for limitations)	7 Compensation of officers		7	
	8 Salaries and wages (less employment credits)		8	
	9 Repairs and maintenance		9	
	10 Bad debts		10	
	11 Rents		11	
	12 Taxes and licenses		12	
	13 Interest		13	
	14a Depreciation (if required, attach Form 4562)	14a		
	b Depreciation claimed on Schedule A and elsewhere on return	14b		
	c Subtract line 14b from line 14a		14c	
	15 Depletion (Do not deduct oil and gas depletion.)		15	
	16 Advertising		16	
	17 Pension, profit-sharing, etc. plans		17	
	18 Employee benefit programs		18	
	19 Other deductions (attach schedule)		19	
	20 Total deductions. Add the amounts shown in the far right column for lines 7 through 19		▶ 20	
	21 Ordinary income (loss) from trade or business activities. Subtract line 20 from line 6		21	
Tax and Payments	22 Tax: a Excess net passive income tax (attach schedule)	22a		
	b Tax from Schedule D (Form 1120S)	22b		
	c Add lines 22a and 22b (see page 14 of the instructions for additional taxes)		22c	
	23 Payments: a 1999 estimated tax payments and amount applied from 1998 return	23a		
	b Tax deposited with Form 7004	23b	NONE	
	c Credit for Federal tax paid on fuels (attach Form 4136)	23c		
	d Add lines 23a through 23c		23d	NONE
	24 Estimated tax penalty. Check if Form 2220 is attached	▶ [ ]	24	
	25 Tax due. If the total of lines 22c and 24 is larger than line 23d, enter amount owed. See page 4 of the instructions for depository method of payment	▶	25	
	26 Overpayment. If line 23d is larger than the total of lines 22c and 24, enter amount overpaid	▶	26	NONE
	27 Enter amount of line 26 you want: Credited to 2000 estimated tax ▶ Refunded ▶		27	NONE

RECEIVED
MAR 2000
OGDEN, UTAH

Please Sign Here

Under penalties of perjury, I declare that I have examined this return, including accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge.

▶ Signature of officer 3-27-00 ▶ PRESIDENT
Date Title

Paid Preparer's Use Only

Preparer's signature ▶	Date	Check if self-employed ▶ [ ]	Preparer's SSN or PTIN
Stewart Gordon CPA	3/20/00		P00899762
Firm's name (or yours if self-employed) and address ▶ ERNST & YOUNG LLP, 1150 18TH STREET NW, SUITE 500, WASHINGTON, DC		EIN ▶ 34-6565596	ZIP code ▶ 20036

For Paperwork Reduction Act Notice, see the separate instructions. Form **1120S** (1999)

*** INITIAL RETURN ***

JW3813 1266 03/17/2000 15:32:58 V9.06 01 74-2936189 3

0252 0002

Schedule A Cost of Goods Sold (see page 15 of the instructions)

1	Inventory at beginning of year	1	
2	Purchases	2	
3	Cost of labor	3	
4	Additional section 263A costs *(attach schedule)*	4	
5	Other costs *(attach schedule)*	5	
6	**Total.** Add lines 1 through 5	6	
7	Inventory at end of year	7	
8	**Cost of goods sold.** Subtract line 7 from line 6. Enter here and on page 1, line 2	8	

9a Check all methods used for valuing closing inventory

(i) ☐ Cost as described in Regulations section 1.471-3

(ii) ☐ Lower of cost or market as described in Regulations section 1.471-4

(iii) ☐ Other (specify method used and attach explanation) ▶

b Check if there was a writedown of "subnormal" goods as described in Regulations section 1.471-2(c) ▶ ☐

c Check if the LIFO inventory method was adopted this tax year for any goods *(if checked, attach Form 970)* ▶ ☐

d If the LIFO inventory method was used for this tax year, enter percentage (or amounts) of closing inventory computed under LIFO 9d

e Do the rules of section 263A (for property produced or acquired for resale) apply to the corporation? ☐ Yes ☐ No

f Was there any change in determining quantities, cost, or valuations between opening and closing inventory? ☐ Yes ☐ No

If "Yes," attach explanation

Schedule B Other Information

		Yes	No
1	Check method of accounting (a) [X] Cash (b) ☐ Accrual (c) ☐ Other (specify) ▶		
2	Refer to the list on pages 26 through 28 of the instructions and state the corporation's principal (a) Business activity ▶ INVESTMENT (b) Product or service ▶ INVESTMENT		
3	Did the corporation at the end of the tax year own, directly or indirectly, 50% or more of the voting stock of a domestic corporation? (For rules of attribution, see section 267(c).) If "Yes," attach a schedule showing (a) name, address, and employer identification number and (b) percentage owned		X
4	Was the corporation a member of a controlled group subject to the provisions of section 1561?		X
5	At any time during calendar year 1999, did the corporation have an interest in or a signature or other authority over a financial account in a foreign country (such as a bank account, securities account, or other financial account)? (See page 15 of the instructions for exceptions and filing requirements for Form TD F 90-22.1.) If "Yes," enter the name of the foreign country ▶		X
6	During the tax year, did the corporation receive a distribution from, or was it the grantor of, or transferor to, a foreign trust? If "Yes," the corporation may have to file Form 3520. See page 15 of the instructions		X
7	Check this box if the corporation has filed or is required to file **Form 8264**, Application for Registration of a Tax Shelter ▶ ☐		
8	Check this box if the corporation issued publicly offered debt instruments with original issue discount ▶ ☐ If so, the corporation may have to file **Form 8281**, Information Return for Publicly Offered Original Issue Discount Instruments.		
9	If the corporation (a) filed its election to be an S corporation after 1986, (b) was a C corporation before it elected to be an S corporation or the corporation acquired an asset with a basis determined by reference to its basis (or the basis of any other property) in the hands of a C corporation, and (c) has net unrealized built-in gain (defined in section 1374(d)(1)) in excess of the net recognized built-in gain from prior years, enter the net unrealized built-in gain reduced by net recognized built-in gain from prior years (see page 15 of the instructions) ▶		
10	Check this box if the corporation had accumulated earnings and profits at the close of the tax year (see page 16 of the instructions) ▶ ☐		

Schedule K **Shareholders' Shares of Income, Credits, Deductions, etc.**

		(a) Pro rata share items		(b) Total amount
Income (Loss)	1	Ordinary income (loss) from trade or business activities (page 1, line 21)	1	
	2	Net income (loss) from rental real estate activities (attach Form 8825)	2	
	3a	Gross income from other rental activities 3a		
	b	Expenses from other rental activities (attach schedule) 3b		
	c	Net income (loss) from other rental activities. Subtract line 3b from line 3a	3c	
	4	Portfolio income (loss):		
	a	Interest income	4a	
	b	Ordinary dividends	4b	
	c	Royalty income	4c	
	d	Net short-term capital gain (loss) (attach Schedule D (Form 1120S))	4d	-32,297,786.
	e	Net long-term capital gain (loss) (attach Schedule D (Form 1120S)):		
		(1) 28% rate gain (loss) ▶ (2) Total for year ▶	4e(2)	
	f	Other portfolio income (loss) (attach schedule)	4f	
	5	Net section 1231 gain (loss) (other than due to casualty or theft) (attach Form 4797)	5	
	6	Other income (loss) (attach schedule)	6	
Deductions	7	Charitable contributions (attach schedule)	7	
	8	Section 179 expense deduction (attach Form 4562)	8	
	9	Deductions related to portfolio income (loss) (itemize)	9	
	10	Other deductions (attach schedule)	10	
Investment Interest	11a	Interest expense on investment debts	11a	
	b	(1) Investment income included on lines 4a, 4b, 4c, and 4f above	11b(1)	
		(2) Investment expenses included on line 9 above	11b(2)	
Credits	12a	Credit for alcohol used as a fuel (attach Form 6478)	12a	
	b	Low-income housing credit:		
		(1) From partnerships to which section 42(j)(5) applies for property placed in service before 1990	12b(1)	
		(2) Other than on line 12b(1) for property placed in service before 1990	12b(2)	
		(3) From partnerships to which section 42(j)(5) applies for property placed in service after 1989	12b(3)	
		(4) Other than on line 12b(3) for property placed in service after 1989	12b(4)	
	c	Qualified rehabilitation expenditures related to rental real estate activities (attach Form 3468)	12c	
	d	Credits (other than credits shown on lines 12b and 12c) related to rental real estate activities	12d	
	e	Credits related to other rental activities	12e	
	13	Other credits	13	
Adjustments and Tax Preference Items	14a	Depreciation adjustment on property placed in service after 1986	14a	
	b	Adjusted gain or loss	14b	
	c	Depletion (other than oil and gas)	14c	
	d	(1) Gross income from oil, gas, or geothermal properties	14d(1)	
		(2) Deductions allocable to oil, gas, or geothermal properties	14d(2)	
	e	Other adjustments and tax preference items (attach schedule)	14e	
Foreign Taxes	15a	Type of income ▶		
	b	Name of foreign country or U.S. possession		
	c	Total gross income from sources outside the United States (attach schedule)	15c	
	d	Total applicable deductions and losses (attach schedule)	15d	
	e	Total foreign taxes (check one): ▶ ☐ Paid ☐ Accrued	15e	
	f	Reduction in taxes available for credit (attach schedule)	15f	
	g	Other foreign tax information (attach schedule)	15g	
Other	16	Section 59(e)(2) expenditures: a Type ▶ b Amount ▶	16b	
	17	Tax-exempt interest income	17	
	18	Other tax-exempt income	18	
	19	Nondeductible expenses	19	
	20	Total property distributions (including cash) other than dividends reported on line 22 below	20	
	21	Other items and amounts required to be reported separately to shareholders (attach schedule)		
	22	Total dividend distributions paid from accumulated earnings and profits	22	
	23	Income (loss). (Required only if Schedule M-1 must be completed.) Combine lines 1 through 6 in column (b). From the result, subtract the sum of lines 7 through 11a, 15e, and 16b	23	-32,297,786.

Schedule L Balance Sheets per Books

Assets	Beginning of tax year (a)	Beginning of tax year (b)	End of tax year (c)	End of tax year (d)
1 Cash				2,468,172.
2a Trade notes and accounts receivable				
b Less allowance for bad debts				
3 Inventories				
4 U.S. Government obligations				
5 Tax-exempt securities				
6 Other current assets (attach schedule)				
7 Loans to shareholders				
8 Mortgage and real estate loans				
9 Other investments (attach schedule)				
10a Buildings and other depreciable assets				
b Less accumulated depreciation				
11a Depletable assets				
b Less accumulated depletion				
12 Land (net of any amortization)				
13a Intangible assets (amortizable only)				
b Less accumulated amortization				
14 Other assets (attach schedule)				
15 Total assets				2,468,172.
Liabilities and Shareholders' Equity				
16 Accounts payable				
17 Mortgages, notes, bonds payable in less than 1 year				
18 Other current liabilities (attach schedule)				
19 Loans from shareholders				
20 Mortgages, notes, bonds payable in 1 year or more				
21 Other liabilities (attach schedule)				
22 Capital stock				100.
23 Additional paid-in capital				34,765,858.
24 Retained earnings				-32,297,786.
25 Adjustments to shareholders' equity (attach schedule)				
26 Less cost of treasury stock		( )		( )
27 Total liabilities and shareholders' equity				2,468,172.

Schedule M-1 Reconciliation of Income (Loss) per Books With Income (Loss) per Return (You are not required to complete this schedule if the total assets on line 15, column (d), of Schedule L are less than $25,000.)

1 Net income (loss) per books	-32,297,786.	5 Income recorded on books this year not included on Schedule K, lines 1 through 6 (itemize):	
2 Income included on Schedule K, lines 1 through 6, not recorded on books this year (itemize)		a Tax-exempt interest	
3 Expenses recorded on books this year not included on Schedule K, lines 1 through 11a, 15e, and 16b (itemize):		6 Deductions included on Schedule K, lines 1 through 11a, 15e, and 16b, not charged against book income this year (itemize):	
a Depreciation		a Depreciation	
b Travel and entertainment		7 Add lines 5 and 6	
		8 Income (loss) (Schedule K, line 23). Line 4 less line 7	-32,297,786.
4 Add lines 1 through 3	-32,297,786.		

Schedule M-2 Analysis of Accumulated Adjustments Account, Other Adjustments Account, and Shareholders' Undistributed Taxable Income Previously Taxed (see page 24 of the instructions)

	(a) Accumulated adjustments account	(b) Other adjustments account	(c) Shareholders' undistributed taxable income previously taxed
1 Balance at beginning of tax year			
2 Ordinary income from page 1, line 21			
3 Other additions			
4 Loss from page 1, line 21	( )		
5 Other reductions SEE STATEMENT 1.	(32,297,786.)	( )	
6 Combine lines 1 through 5	-32,297,786.		
7 Distributions other than dividend distributions			
8 Balance at end of tax year. Subtract line 7 from line 6	-32,297,786.		

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SCHEDULE D (Form 1120S)

Department of the Treasury
Internal Revenue Service

Capital Gains and Losses and Built-In Gains

▶ Attach to Form 1120S.

▶ See separate instructions.

OMB No. 1545-0130

1999

Name

SA TESORO DRIVE INVESTORS INC.

Employer identification number

74-2936189

Part I Short-Term Capital Gains and Losses - Assets Held One Year or Less

(a) Description of property (Example, 100 shares of "Z" Co.)	(b) Date acquired (mo., day, yr.)	(c) Date sold (mo., day, yr.)	(d) Sales price	(e) Cost or other basis (see instructions)	(f) Gain or (loss) ((d) minus (e))
1 SEE STATEMENT 2					-32,297,786.

2	Short-term capital gain from installment sales from Form 6252, line 26 or 37	2	
3	Short-term capital gain or (loss) from like-kind exchanges from Form 8824	3	
4	Combine lines 1 through 3 in column (f) and enter here	4	-32,297,786.
5	Tax on short-term capital gain included on line 32 below	5	( )
6	**Net short-term capital gain or (loss).** Combine lines 4 and 5. Enter here and on Form 1120S, Schedule K, line 4d or 6	6	-32,297,786.

Part II Long-Term Capital Gains and Losses - Assets Held More Than One Year

(a) Description of property (Example, 100 shares of "Z" Co.)	(b) Date acquired (mo., day, yr.)	(c) Date sold (mo., day, yr.)	(d) Sales price	(e) Cost or other basis (see instructions)	(f) Gain or (loss) for entire year ((d) minus (e))	(g) 28% rate gain or (loss) *(see instr. below)
7						

8	Long-term capital gain from installment sales from Form 6252, line 26 or 37	8		
9	Long-term capital gain or (loss) from like-kind exchanges from Form 8824	9		
10	Combine lines 7 through 9 in column (f) and enter here	10		
11	Tax on long-term capital gain included on lines 24 and 32 below	11	( )	( )
12	Combine lines 7 through 11 in column (g). Enter here and on Form 1120S, Schedule K, line 4e(1) or 6	12		
13	**Net long-term capital gain or (loss).** Combine lines 10 and 11 in column (f). Enter here and on Form 1120S, Schedule K, line 4e(2) or 6	13		

* 28% rate gain or (loss) includes ALL "collectibles gains and losses" (as defined in the instructions)

Part III Capital Gains Tax (See instructions before completing this part.)

14	Enter section 1231 gain from Form 4797, line 9	14	
15	Net long-term capital gain or (loss). Combine lines 10 and 14	15	
	***Note:** If the corporation is liable for the excess net passive income tax (Form 1120S, page 1, line 22a) or the built-in gains tax (Part IV below), see the line 16 instructions before completing line 16.*		
16	Net capital gain. Enter excess of net long-term capital gain (line 15) over net short-term capital loss (line 4)	16	
17	Statutory minimum	17	$25,000
18	Subtract line 17 from line 16	18	
19	Enter 34% of line 18	19	
20	Taxable income (attach computation schedule)	20	
21	Enter tax on line 20 amount (attach computation schedule)	21	
22	Net capital gain from substituted basis property (attach computation schedule)	22	
23	Enter 35% of line 22	23	
24	**Tax.** Enter the smallest of line 19, 21, or 23 here and on Form 1120S, page 1, line 22b	24	

Part IV Built-In Gains Tax (See instructions before completing this part.)

25	Excess of recognized built-in gains over recognized built-in losses (attach computation schedule)	25	
26	Taxable income (attach computation schedule)	26	
27	Net recognized built-in gain. Enter smallest of line 25, line 26, or line 9 of Schedule B	27	
28	Section 1374(b)(2) deduction	28	
29	Subtract line 28 from line 27. If zero or less, enter -0- here and online 32	29	
30	Enter 35% of line 29	30	
31	Business credit and minimum tax credit carryforwards under section 1374(b)(3) from C corporation years	31	
32	**Tax.** Subtract line 31 from line 30 (if zero or less, enter -0-). Enter here and on Form 1120S, page 1, line 22b	32	

For Paperwork Reduction Act Notice, see the instructions for Form 1120S.

Schedule D (Form 1120S) 1999

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Form **7004**
(Rev. July 1998)
Department of the Treasury
Internal Revenue Service

Application for Automatic Extension of Time To File Corporation Income Tax Return

OMB No 1545-0233

Name of corporation
SA TESORO DRIVE INVESTORS INC.

Employer identification number
74-2936189

Number, street, and room or suite no. (If a P.O. box or outside the United States, see instructions.)
9000 TESORO DRIVE, SUITE 122

City or town, state, and ZIP code
SAN ANTONIO TX 78217

Check type of return to be filed

☐ Form 1120	☐ Form 1120-FSC	☐ Form 1120-ND	☐ Form 1120-REIT	☐ Form 1120-SF
☐ Form 1120-A	☐ Form 1120-H	☐ Form 1120-PC	☐ Form 1120-RIC	
☐ Form 1120-F	☐ Form 1120-L	☐ Form 1120-POL	☒ Form 1120S	

☐ Form 990-C
☐ Form 990-T ▶

Note: *Other 990 filers (i.e. Form 990, 990-EZ, 990-BL, 990-PF, and certain filers of Form 990-T (see instructions)) must use Form 2758 to request extension of time to file.*

Form 1120-F filers: Check here if you do not have an office or place of business in the United States . . . ▶ ☐

1a I request an automatic 6-month (or, for certain corporations, 3-month) extension of time
until SEPTEMBER 15, 2000, to file the income tax return of the corporation named above for ▶ ☐ calendar year ____ or ▶ ☒ tax year beginning NOVEMBER 12, 1999, and ending DECEMBER 31, 1999

b If this tax year is for less than 12 months, check reason
☒ Initial return ☐ Final return ☐ Change in accounting period ☐ Consolidated return to be filed

2 If this application also covers subsidiaries to be included in a consolidated return, complete the following

Name and address of each member of the affiliated group	Employer identification number	Tax period

3 Tentative tax (see instructions)		3	NONE
4 Credits:			
a Overpayment credited from prior year	4a		
b Estimated tax payments for the tax year	4b		
c Less refund for the tax year applied for on Form 4466	4c	Bal ▶ 4d	
e Credit for tax paid on undistributed capital gains (Form 2439)		4e	
f Credit for Federal tax on fuels (Form 4136)		4f	
5 Total. Add lines 4d through 4f		5	NONE
6 Balance due. Subtract line 5 from line 3. Deposit this amount electronically or with a Federal Tax Deposit (FTD) Coupon (see instructions)		6	NONE

Signature. Under penalties of perjury, I declare that I have been authorized by the above named corporation to make this application, and to the best of my knowledge and belief, the statements made are true, correct, and complete.

(Signature of officer or agent) (Title) (Date)

For Paperwork Reduction Act Notice, see instructions. JSA Form **7004** (Rev. 7-98)

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FORM 1120S, PAGE 4 DETAIL

SCH M-2, LINE 5 - OTHER REDUCTIONS AAA

NET SHORT-TERM CAPITAL LOSS	32,297,786.
TOTAL	32,297,786.

1999

SA TESORO DRIVE INVESTORS INC.

SCHEDULE D (FORM 1120S) DETAIL

LINE 1 - SHORT-TERM CAPITAL GAINS AND LOSSES

PROPERTY	DATE ACQ	DATE SOLD	SALES PRICE	COST	GAIN/LOSS
SALE OF STOCK	12/23/99	12/30/99	690,836	32,988,622.	-32,297,786.
TOTAL					-32,297,786.

SHAREHOLDER SUMMARY

SH. #	SHAREHOLDER NAME	BEGINNING SHARES	OWNERSHIP PERCENTAGE
1	BILLY MCCOMBS	90.9100	90.000000
2	GARY WOODS	9.0900	10.000000

201

SCHEDULE K-1 (Form 1120S)	Shareholder's Share of Income, Credits, Deductions, etc.	OMB No. 1545-0130
Department of the Treasury Internal Revenue Service	▶ See separate instructions. For calendar year 1999 or tax year beginning 11/12, 1999, and ending 12/31, 1999	1999

Shareholder's identifying number ▶ 467-26-3574	Corporation's identifying number ▶ 74-2936189
Shareholder's name, address, and ZIP code	Corporation's name, address, and ZIP code
BILLY MCCOMBS 9000 TESORO DRIVE SUITE 122 SAN ANTONIO, TX 78217	SA TESORO DRIVE INVESTORS INC. 9000 TESORO DRIVE, SUITE 122 SAN ANTONIO TX 78217

A Shareholder's percentage of stock ownership for tax year (see instructions for Schedule K-1) . . . ▶ 90.000000 %

B Internal Revenue Service Center where corporation filed its return ▶ AUSTIN, TX 73301

C Tax shelter registration number (see instructions for Schedule K-1) ▶

D Check applicable boxes: (1) ☐ Final K-1 (2) ☐ Amended K-1

		(a) Pro rata share items		(b) Amount	(c) Form 1040 filers enter the amount in column (b) on
Income (Loss)	1	Ordinary income (loss) from trade or business activities	1		See pages 4 and 5 of the Shareholder's Instructions for Schedule K-1 (Form 1120S)
	2	Net income (loss) from rental real estate activities	2		
	3	Net income (loss) from other rental activities	3		
	4	Portfolio income (loss)			
	a	Interest	4a		Sch. B, Part I, line 1
	b	Ordinary dividends	4b		Sch. B, Part II, line 5
	c	Royalties	4c		Sch. E, Part I, line 4
	d	Net short-term capital gain (loss)	4d	-29,068,007.	Sch. D, line 5, col. (f)
	e	Net long-term capital gain (loss)			
		(1) 28% rate gain (loss)	e(1)		Sch. D, line 12, col. (g)
		(2) Total for year	e(2)		Sch. D, line 12, col. (f)
	f	Other portfolio income (loss) *(attach schedule)*	4f		(Enter on applicable line of your return.)
	5	Net section 1231 gain (loss) (other than due to casualty or theft)	5		See Shareholder's Instructions for Schedule K-1 (Form 1120S)
	6	Other income (loss) *(attach schedule)*	6		(Enter on applicable line of your return.)
Deductions	7	Charitable contributions *(attach schedule)*	7		Sch. A, line 15 or 16
	8	Section 179 expense deduction	8		See page 6 of the Shareholder's Instructions for Schedule K-1 (Form 1120S)
	9	Deductions related to portfolio income (loss) *(attach schedule)*	9		
	10	Other deductions *(attach schedule)*	10		
Investment Interest	11a	Interest expense on investment debts	11a		Form 4952, line 1
	b	(1) Investment income included on lines 4a, 4b, 4c, and 4f above	b(1)		See Shareholder's Instructions for Schedule K-1 (Form 1120S)
		(2) Investment expenses included on line 9 above	b(2)		
Credits	12a	Credit for alcohol used as fuel	12a		Form 6478, line 10
	b	Low-income housing credit:			
		(1) From section 42(j)(5) partnerships for property placed in service before 1990	b(1)		Form 8586, line 5
		(2) Other than on line 12b(1) for property placed in service before 1990	b(2)		
		(3) From section 42(j)(5) partnerships for property placed in service after 1989	b(3)		
		(4) Other than on line 12b(3) for property placed in service after 1989	b(4)		
	c	Qualified rehabilitation expenditures related to rental real estate activities	12c		See page 7 of the Shareholder's Instructions for Schedule K-1 (Form 1120S)
	d	Credits (other than credits shown on lines 12b and 12c) related to rental real estate activities	12d		
	e	Credits related to other rental activities	12e		
	13	Other credits	13		

For Paperwork Reduction Act Notice, see the Instructions for Form 1120S. Schedule K-1 (Form 1120S) 1999

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	(a) Pro rata share items		(b) Amount	(c) Form 1040 filers enter the amount in column (b) on
Adjustments and Tax Preference Items	14a Depreciation adjustment on property placed in service after 1986	14a		See page 7 of the Shareholder's Instructions for Schedule K-1 (Form 1120S) and Instructions for Form 6251
	b Adjusted gain or loss	14b		
	c Depletion (other than oil and gas)	14c		
	d (1) Gross income from oil, gas, or geothermal properties	d(1)		
	(2) Deductions allocable to oil, gas, or geothermal properties	d(2)		
	e Other adjustments and tax preference items *(attach schedule)*	14e		
Foreign Taxes	15a Type of income ▶			Form 1116, Check boxes
	b Name of foreign country or U.S. possession ▶			
	c Total gross income from sources outside the United States *(attach schedule)*	15c		Form 1116, Part I
	d Total applicable deductions and losses *(attach schedule)*	15d		
	e Total foreign taxes (check one) ▶ ☐ Paid ☐ Accrued	15e		Form 1116, Part II
	f Reduction in taxes available for credit *(attach schedule)*	15f		Form 1116, Part III
	g Other foreign tax information *(attach schedule)*	15g		See instructions for Form 1116
Other	16 Section 59(e)(2) expenditures: Type ▶			See Shareholder's Instructions for Schedule K-1 (Form 1120S)
	b Amount	16b		
	17 Tax-exempt interest income	17		Form 1040, line 8b
	18 Other tax-exempt income	18		See page 7 and 8 of the Shareholder's Instructions for Schedule K-1 (Form 1120S)
	19 Nondeductible expenses	19		
	20 Property distributions (including cash) other than dividend distributions reported to you on Form 1099-DIV	20		
	21 Amount of loan repayments for "Loans From Shareholders"	21		
	22 Recapture of low-income housing credit			
	a From section 42(j)(5) partnerships	22a		Form 8611, line 8
	b Other than on line 22a	22b		

Supplemental Information

23 Supplemental information required to be reported separately to each shareholder *(attach additional schedules if more space is needed)*

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2003

SCHEDULE K-1 (Form 1120S)

Department of the Treasury Internal Revenue Service

Shareholder's Share of Income, Credits, Deductions, etc.

▶ See separate instructions.

For calendar year 1999 or tax year beginning 11/12, 1999, and ending 12/31, 1999

OMB No. 1545-0130

1999

Shareholder's identifying number ▶ 463-60-1990	Corporation's identifying number ▶ 74-2936189
Shareholder's name, address, and ZIP code	Corporation's name, address, and ZIP code
GARY WOODS 9000 TESORO DRIVE SUITE 122 SAN ANTONIO, TX 78217	SA TESORO DRIVE INVESTORS INC. 9000 TESORO DRIVE, SUITE 122 SAN ANTONIO TX 78217

A Shareholder's percentage of stock ownership for tax year (see instructions for Schedule K-1) ▶ 10.000000 %

B Internal Revenue Service Center where corporation filed its return ▶ AUSTIN, TX 73301

C Tax shelter registration number (see instructions for Schedule K-1) ▶

D Check applicable boxes (1) ☐ Final K-1 (2) ☐ Amended K-1

	(a) Pro rata share items		(b) Amount	(c) Form 1040 filers enter the amount in column (b) on
Income (Loss)	1 Ordinary income (loss) from trade or business activities	1		See pages 4 and 5 of the Shareholder's Instructions for Schedule K-1 (Form 1120S)
	2 Net income (loss) from rental real estate activities	2		
	3 Net income (loss) from other rental activities	3		
	4 Portfolio income (loss)			
	a Interest	4a		Sch. B, Part I, line 1
	b Ordinary dividends	4b		Sch. B, Part II, line 5
	c Royalties	4c		Sch. E, Part I, line 4
	d Net short-term capital gain (loss)	4d	-3,229,779.	Sch. D, line 5, col. (f)
	e Net long-term capital gain (loss)			
	(1) 28% rate gain (loss)	e(1)		Sch. D, line 12, col. (g)
	(2) Total for year	e(2)		Sch. D, line 12, col. (f)
	f Other portfolio income (loss) (attach schedule)	4f		(Enter on applicable line of your return.)
	5 Net section 1231 gain (loss) (other than due to casualty or theft)	5		See Shareholder's Instructions for Schedule K-1 (Form 1120S)
	6 Other income (loss) (attach schedule)	6		(Enter on applicable line of your return.)
Deductions	7 Charitable contributions (attach schedule)	7		Sch. A, line 15 or 16
	8 Section 179 expense deduction	8		See page 6 of the Shareholder's Instructions for Schedule K-1 (Form 1120S)
	9 Deductions related to portfolio income (loss) (attach schedule)	9		
	10 Other deductions (attach schedule)	10		
Investment Interest	11a Interest expense on investment debts	11a		Form 4952, line 1
	b (1) Investment income included on lines 4a, 4b, 4c, and 4f above	b(1)		See Shareholder's Instructions for Schedule K-1 (Form 1120S)
	(2) Investment expenses included on line 9 above	b(2)		
Credits	12a Credit for alcohol used as fuel	12a		Form 6478, line 10
	b Low-income housing credit			
	(1) From section 42(j)(5) partnerships for property placed in service before 1990	b(1)		Form 8586, line 5
	(2) Other than on line 12b(1) for property placed in service before 1990	b(2)		
	(3) From section 42(j)(5) partnerships for property placed in service after 1989	b(3)		
	(4) Other than on line 12b(3) for property placed in service after 1989	b(4)		
	c Qualified rehabilitation expenditures related to rental real estate activities	12c		See page 7 of the Shareholder's Instructions for Schedule K-1 (Form 1120S)
	d Credits (other than credits shown on lines 12b and 12c) related to rental real estate activities	12d		
	e Credits related to other rental activities	12e		
	13 Other credits	13		

For Paperwork Reduction Act Notice, see the Instructions for Form 1120S.

Schedule K-1 (Form 1120S) 1999

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	(a) Pro rata share items		(b) Amount	(c) Form 1040 filers enter the amount in column (b) on
Adjustments and Tax Preference Items	14a Depreciation adjustment on property placed in service after 1986	14a		See page 7 of the Shareholder's Instructions for Schedule K-1 (Form 1120S) and Instructions for Form 6251
	b Adjusted gain or loss	14b		
	c Depletion (other than oil and gas)	14c		
	d (1) Gross income from oil, gas, or geothermal properties	d(1)		
	(2) Deductions allocable to oil, gas, or geothermal properties	d(2)		
	e Other adjustments and tax preference items (attach schedule)	14e		
Foreign Taxes	15a Type of income ▶			Form 1116, Check boxes
	b Name of foreign country or U.S. possession ▶			
	c Total gross income from sources outside the United States (attach schedule)	15c		Form 1116, Part I
	d Total applicable deductions and losses (attach schedule)	15d		
	e Total foreign taxes (check one) ▶ ☐ Paid ☐ Accrued	15e		Form 1116, Part II
	f Reduction in taxes available for credit (attach schedule)	15f		Form 1116, Part III
	g Other foreign tax information (attach schedule)	15g		See instructions for Form 1116
Other	16 Section 59(e)(2) expenditures a Type ▶			See Shareholder's Instructions for Schedule K-1 (Form 1120S)
	b Amount	16b		
	17 Tax-exempt interest income	17		Form 1040, line 8b
	18 Other tax-exempt income	18		
	19 Nondeductible expenses	19		See page 7 and 8 of the Shareholder's Instructions for Schedule K-1 (Form 1120S)
	20 Property distributions (including cash) other than dividend distributions reported to you on Form 1099-DIV	20		
	21 Amount of loan repayments for "Loans From Shareholders"	21		
	22 Recapture of low-income housing credit			
	a From section 42(j)(5) partnerships	22a		Form 8611, line 8
	b Other than on line 22a	22b		

Supplemental Information

23 Supplemental information required to be reported separately to each shareholder (attach additional schedules if more space is needed)

SA TESORO INVESTORS, INC.
E.I.N. 74-2936189
FORM 1120S, FYE 12/31/99

TRANSFEREE CORPORATION'S STATEMENT
UNDER REGULATION IRC SEC. 1.351-3(b)

(1) & (2) Property received and adjusted basis of that property to transferor - On December 27, 1999, transferee, in exchange for the consideration set out in paragraph (3) et. seq. of this statement, received the property listed below. The adjusted basis of each item of property to the transferor as of the date of the transfer is set out in the column entitled, "Tax Basis"

(a) From Billy J. McCombs:

Property	Tax Basis
Partnership interest in SA Tesoro Investment Partners	$30,641,362

From Gary Woods:

Property	Tax Basis
Partnership interest in SA Tesoro Investment Partners	$3,404,596

The property above is listed in detail in the transferee's permanent books of account.

(3) Information about transferee's capital stock:

(i) Total issued and outstanding capital stock of transferee immediately before and immediately after the exchange.

Class of stock	No. of share outstanding immediately before exchange	No. of shares outstanding immediately after exchange
Common	None	100

(ii) Immediately after the exchange, the transferors owned 100 of the 100 shares issued of transferee's common stock and, therefore, 100% of the outstanding shares. Ownership of stock is as follows:

Billy J. McCombs	90 shares
Gary Woods	10 shares

(iii) Fair market value of shares issued in exchange - Each share of common stock issued in the exchange had a fair market value of $1 per share.

(4) Information about the transferee's securities: The transferee issued no securities and had no securities outstanding immediately before or after the exchange.

(5) Money paid to transferor in connection with the exchange: No money passed to the transferor.

(6) Other property given to transferor in connection with the exchange: No property other than common stock with fair market value of $100 was passed to the transferor in connection with this exchange.

(7) Liabilities of transferor assumed by transferee in connection with exchange: The transferee did not assume any liabilities in connection with this exchange.

Department of the Treasury
Internal Revenue Service

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Date October 1, 2007

CERTIFICATE OF OFFICIAL RECORD

I certify that the annexed: is a and complete copy of the U. S. Income Tax Return for an S Corporation, (Form 1120S) for Tesoro Drive Investors Inc., EIN: 74-2936191, 9000 Tesoro Drive, Suite 122, San Antonio, Texas 78217, for calendar year beginning November 12, 1999 and ending December 31, 1999, which was received in the regular course of business of the Internal Revenue Service and consists of fourteen (14) pages

under the custody of this office.

IN WITNESS WHEREOF, I have hereunto set my hand, and caused the seal of this office to be affixed, on the day and year first above written.

By direction of the Secretary of the Treasury:

Thomas D. Mathews
Director Advisory, Insolvency & Quality
Small Business Self Employed Division

for Felix J. Carrillo Jr.
Technical Services Group Manager, Houston
Small Business Self Employed Division

Form 2866

D0254

DEFENDANT'S EXHIBIT 254

18316092088819-0

Form **1120S** — Department of the Treasury, Internal Revenue Service

U.S. Income Tax Return for an S Corporation

▶ Do not file this form unless the corporation has timely filed Form 2553 to elect to be an S corporation.
▶ See separate instructions.

OMB No. 1545-0130

1999

For calendar year 1999, or tax year beginning 11/12/1999 and ending 12/31/1999

A Effective date of election as an S corporation	Use IRS label. Otherwise, please print or type.	Name	C Employer identification number
11/12/1999		TESORO DRIVE INVESTORS, INC.	74-2936191
B Business code no. (see pages 29-39)		Number, street, and room or suite no. (If a P.O. box, see page 10 of the instructions.)	D Date incorporated
523900		9000 TESORO DRIVE, SUITE 120 AUSPC SO. 016 23	11/12/1999
		City or town, state, and ZIP code	E Total assets (see page 10)
		SAN ANTONIO, TX 78217	1,557,639.

F Check applicable boxes: (1) [X] Initial return (2) [ ] Final return (3) [ ] Change in address (4) [ ] Amended return

G Enter number of shareholders in the corporation at end of the tax year ▶ 2

Caution: Include only trade or business income and expenses on lines 1a through 21. See page 10 of the instructions for more information.

Income	1a Gross receipts or sales	b Less returns and allowances	c Bal ▶ 1c	
	2 Cost of goods sold (Schedule A, line 8)		2	
	3 Gross profit. Subtract line 2 from line 1c		3	
	4 Net gain (loss) from Form 4797, Part II, line 18 (attach Form 4797)		4	-13,353,162.
	5 Other income (loss) (attach schedule)		5	
	6 Total income (loss). Combine lines 3 through 5		▶ 6	-13,353,162.
Deductions (see page 11 of the instructions for limitations)	7 Compensation of officers		7	
	8 Salaries and wages (less employment credits)		8	
	9 Repairs and maintenance		9	
	10 Bad debts		10	
	11 Rents		11	
	12 Taxes and licenses		12	
	13 Interest		13	
	14a Depreciation (if required, attach Form 4562)	14a		
	b Depreciation claimed on Schedule A and elsewhere on return	14b		
	c Subtract line 14b from line 14a		14c	
	15 Depletion (Do not deduct oil and gas depletion.)		15	
	16 Advertising		16	
	17 Pension, profit-sharing, etc. plans		17	
	18 Employee benefit programs		18	
	19 Other deductions (attach schedule)		19	
	20 Total deductions. Add the amounts shown in the far right column for lines 7 through 19		▶ 20	
	21 Ordinary income (loss) from trade or business activities. Subtract line 20 from line 6		21	-13,353,162.
Tax and Payments	22 Tax: a Excess net passive income tax (attach schedule)	22a		
	b Tax from Schedule D (Form 1120S)	22b		
	c Add lines 22a and 22b (see page 14 of the instructions for additional taxes)		22c	
	23 Payments: a 1999 estimated tax payments and amount applied from 1998 return	23a		
	b Tax deposited with Form 7004	23b	NONE	
	c Credit for Federal tax paid on fuels (attach Form 4136)	23c		
	d Add lines 23a through 23c		23d	NONE
	24 Estimated tax penalty. Check if Form 2220 is attached	▶ [ ]	24	
	25 Tax due. If the total of lines 22c and 24 is larger than line 23d, enter amount owed. See page 4 of the instructions for depository method of payment	▶	25	
	26 Overpayment. If line 23d is larger than the total of lines 22c and 24, enter amount overpaid	▶	26	NONE
	27 Enter amount of line 26 you want: Credited to 2000 estimated tax ▶	Refunded ▶	27	NONE

RECEIVED
MAR 13 2000
AUSTIN, TEXAS

Please Sign Here

Under penalties of perjury, I declare that I have examined this return, including accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge.

▶ Signature of officer — Date: 3-27-00 — ▶ Title: PRESIDENT

Paid Preparer's Use Only

Preparer's signature ▶	Date	Check if self-employed ▶ [ ]	Preparer's SSN or PTIN
Stewart Bowden, CPA	3/20/00		P00844462
Firm's name (or yours if self-employed) and address ▶ ERNST & YOUNG LLP, 1150 18TH STREET NW, SUITE 500, WASHINGTON, DC		EIN ▶	34-6565596
		ZIP code ▶	20036

For Paperwork Reduction Act Notice, see the separate instructions. Form **1120S** (1999)

JSA 9C1443 1.000

*** INITIAL RETURN ***

JW3811 1266 03/17/2000 15:42:49 V9.06.01 74-2936191 3

Form **7004**
(Rev. [illegible])
Department of the Treasury
Internal Revenue Service

Application for Automatic Extension of Time To File Corporation Income Tax Return

OMB No. 1545-0233

Name of corporation
TESORO DRIVE INVESTORS, INC.

Employer identification number
74-2936191

Number, street, and room or suite no. (If a P.O. box or outside the United States, see instructions.)
9000 TESORO DRIVE, SUITE 122

City or town, state, and ZIP code
SAN ANTONIO TX 78217

Check type of return to be filed

☐ Form 1120	☐ Form 1120-FSC	☐ Form 1120-ND	☐ Form 1120-REIT	☐ Form 1120-SF
☐ Form 1120-A	☐ Form 1120-H	☐ Form 1120-PC	☐ Form 1120-RIC	
☐ Form 1120-F	☐ Form 1120-L	☐ Form 1120-POL	☒ Form 1120S	

☐ Form 990-C
☐ Form 990-T ▶

Note: *Other 990 filers (i.e. Form 990, 990-EZ, 990-BL, 990-PF, and certain filers of Form 990-T (see instructions)) must use Form 2758 to request extension of time to file.*

Form 1120-F filers: Check here if you do not have an office or place of business in the United States . . . . . ▶ ☐

1a I request an automatic 6-month (or, for certain corporations, 3-month) extension of time until SEPTEMBER 15, 2000, to file the income tax return of the corporation named above for ▶ ☐ calendar year _____ or ▶ ☒ tax year beginning NOVEMBER 12, 1999 and ending DECEMBER 31, 1999

b If this tax year is for less than 12 months, check reason:
☒ Initial return ☐ Final return ☐ Change in accounting period ☐ Consolidated return to be filed

2 If this application also covers subsidiaries to be included in a consolidated return, complete the following:

Name and address of each member of the affiliated group	Employer identification number	Tax period

3	Tentative tax (see instructions)		3	NONE
4	**Credits:**			
a	Overpayment credited from prior year	4a		
b	Estimated tax payments for the tax year	4b		
c	Less refund for the tax year applied for on Form 4466	4c ( )	4d	
e	Credit for tax paid on undistributed capital gains (Form 2439)		4e	
f	Credit for Federal tax on fuels (Form 4136)		4f	
5	Total. Add lines 4d through 4f		5	NONE
6	**Balance due.** Subtract line 5 from line 3. **Deposit this amount electronically or with a Federal Tax Deposit (FTD) Coupon (see instructions)**		6	NONE

Signature. Under penalties of perjury, I declare that I have been authorized by the above named corporation to make this application, and to the best of my knowledge and belief, the statements made are true, correct, and complete.

(Signature of officer or agent) (Title) (Date)

For Paperwork Reduction Act Notice, see instructions. JSA Form 7004 (Rev. 7-98)

91.990T 4.000

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Schedule A Cost of Goods Sold (see page 15 of the instructions)

1	Inventory at beginning of year	1	
2	Purchases	2	
3	Cost of labor	3	
4	Additional section 263A costs *(attach schedule)*	4	
5	Other costs *(attach schedule)*	5	
6	Total. Add lines 1 through 5	6	
7	Inventory at end of year	7	
8	Cost of goods sold. Subtract line 7 from line 6. Enter here and on page 1, line 2	8	

9a Check all methods used for valuing closing inventory

(i) ☐ Cost as described in Regulations section 1.471-3

(ii) ☐ Lower of cost or market as described in Regulations section 1.471-4

(iii) ☐ Other (specify method used and attach explanation) ▶

b Check if there was a writedown of "subnormal" goods as described in Regulations section 1.471-2(c) ▶ ☐

c Check if the LIFO inventory method was adopted this tax year for any goods (if checked, attach Form 970) ▶ ☐

d If the LIFO inventory method was used for this tax year, enter percentage (or amounts) of closing inventory computed under LIFO 9d

e Do the rules of section 263A (for property produced or acquired for resale) apply to the corporation? ☐ Yes ☐ No

f Was there any change in determining quantities, cost, or valuations between opening and closing inventory? ☐ Yes ☐ No
If "Yes," attach explanation

Schedule B Other Information

		Yes	No
1	Check method of accounting (a) [X] Cash (b) ☐ Accrual (c) ☐ Other (specify) ▶		
2	Refer to the list on pages 26 through 28 of the instructions and state the corporation's principal (a) Business activity ▶ INVESTMENT (b) Product or service ▶ INVESTMENT		
3	Did the corporation at the end of the tax year own, directly or indirectly, 50% or more of the voting stock of a domestic corporation? (For rules of attribution, see section 267(c).) If "Yes," attach a schedule showing (a) name, address, and employer identification number and (b) percentage owned		X
4	Was the corporation a member of a controlled group subject to the provisions of section 1561?		X
5	At any time during calendar year 1999, did the corporation have an interest in or a signature or other authority over a financial account in a foreign country (such as a bank account, securities account, or other financial account)? (See page 15 of the instructions for exceptions and filing requirements for Form TD F 90-22.1.) If "Yes," enter the name of the foreign country ▶		X
6	During the tax year, did the corporation receive a distribution from, or was it the grantor of, or transferor to, a foreign trust? If "Yes," the corporation may have to file Form 3520. See page 15 of the instructions.		X
7	Check this box if the corporation has filed or is required to file Form 8264, Application for Registration of a Tax Shelter ▶ ☐		
8	Check this box if the corporation issued publicly offered debt instruments with original issue discount ▶ ☐ If so, the corporation may have to file Form 8281, Information Return for Publicly Offered Original Issue Discount Instruments		
9	If the corporation (a) filed its election to be an S corporation after 1986, (b) was a C corporation before it elected to be an S corporation or the corporation acquired an asset with a basis determined by reference to its basis (or the basis of any other property) in the hands of a C corporation, and (c) has net unrealized built-in gain (defined in section 1374(d)(1)) in excess of the net recognized built-in gain from prior years, enter the net unrealized built-in gain reduced by net recognized built-in gain from prior years (see page 15 of the instructions) ▶		
10	Check this box if the corporation had accumulated earnings and profits at the close of the tax year (see page 16 of the instructions) ▶ ☐		

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Schedule K **Shareholders' Shares of Income, Credits, Deductions, etc.**

		(a) Pro rata share items		(b) Total amount
Income (Loss)	1	Ordinary income (loss) from trade or business activities (page 1, line 21)	1	-13,353,162.
	2	Net income (loss) from rental real estate activities (attach Form 8825)	2	
	3a	Gross income from other rental activities 3a		
	b	Expenses from other rental activities (attach schedule) 3b		
	c	Net income (loss) from other rental activities. Subtract line 3b from line 3a	3c	
	4	Portfolio income (loss)		
	a	Interest income	4a	
	b	Ordinary dividends	4b	
	c	Royalty income	4c	
	d	Net short-term capital gain (loss) (attach Schedule D (Form 1120S))	4d	
	e	Net long-term capital gain (loss) (attach Schedule D (Form 1120S))		
		(1) 28% rate gain (loss) ▶ (2) Total for year ▶	4e(2)	
	f	Other portfolio income (loss) (attach schedule)	4f	
	5	Net section 1231 gain (loss) (other than due to casualty or theft) (attach Form 4797)	5	
	6	Other income (loss) (attach schedule)	6	
Deductions	7	Charitable contributions (attach schedule)	7	
	8	Section 179 expense deduction (attach Form 4562)	8	
	9	Deductions related to portfolio income (loss) (itemize)	9	
	10	Other deductions (attach schedule)	10	
Investment Interest	11a	Interest expense on investment debts	11a	
	b	(1) Investment income included on lines 4a, 4b, 4c, and 4f above	11b(1)	
		(2) Investment expenses included on line 9 above	11b(2)	
Credits	12a	Credit for alcohol used as a fuel (attach Form 6478)	12a	
	b	Low-income housing credit		
		(1) From partnerships to which section 42(j)(5) applies for property placed in service before 1990	12b(1)	
		(2) Other than on line 12b(1) for property placed in service before 1990	12b(2)	
		(3) From partnerships to which section 42(j)(5) applies for property placed in service after 1989	12b(3)	
		(4) Other than on line 12b(3) for property placed in service after 1989	12b(4)	
	c	Qualified rehabilitation expenditures related to rental real estate activities (attach Form 3468)	12c	
	d	Credits (other than credits shown on lines 12b and 12c) related to rental real estate activities	12d	
	e	Credits related to other rental activities	12e	
	13	Other credits	13	
Adjustments and Tax Preference Items	14a	Depreciation adjustment on property placed in service after 1986	14a	
	b	Adjusted gain or loss	14b	
	c	Depletion (other than oil and gas)	14c	
	d	(1) Gross income from oil, gas, or geothermal properties	14d(1)	
		(2) Deductions allocable to oil, gas, or geothermal properties	14d(2)	
	e	Other adjustments and tax preference items (attach schedule)	14e	
Foreign Taxes	15a	Type of income ▶		
	b	Name of foreign country or U.S. possession		
	c	Total gross income from sources outside the United States (attach schedule)	15c	
	d	Total applicable deductions and losses (attach schedule)	15d	
	e	Total foreign taxes (check one) ▶ ☐ Paid ☐ Accrued	15e	
	f	Reduction in taxes available for credit (attach schedule)	15f	
	g	Other foreign tax information (attach schedule)	15g	
Other	16	Section 59(e)(2) expenditures a Type ▶ b Amount ▶	16b	
	17	Tax-exempt interest income	17	
	18	Other tax-exempt income	18	
	19	Nondeductible expenses	19	
	20	Total property distributions (including cash) other than dividends reported on line 22 below	20	
	21	Other items and amounts required to be reported separately to shareholders (attach schedule)	21	
	22	Total dividend distributions paid from accumulated earnings and profits	22	
	23	Income (loss). (Required only if Schedule M-1 must be completed.) Combine lines 1 through 6 in column (b). From the result, subtract the sum of lines 7 through 11a, 15e, and 16b	23	-13,353,162.

Schedule L Balance Sheets per Books

Assets	Beginning of tax year (a)	(b)	End of tax year (c)	(d)
1 Cash				1,557,639.
2a Trade notes and accounts receivable				
b Less allowance for bad debts				
3 Inventories				
4 U.S. Government obligations				
5 Tax-exempt securities				
6 Other current assets (attach schedule)				
7 Loans to shareholders				
8 Mortgage and real estate loans				
9 Other investments (attach schedule)				
10a Buildings and other depreciable assets				
b Less accumulated depreciation				
11a Depletable assets				
b Less accumulated depletion				
12 Land (net of any amortization)				
13a Intangible assets (amortizable only)				
b Less accumulated amortization				
14 Other assets (attach schedule)				
15 Total assets				1,557,639.
Liabilities and Shareholders' Equity				
16 Accounts payable				
17 Mortgages, notes, bonds payable in less than 1 year				
18 Other current liabilities (attach schedule)				
19 Loans from shareholders				
20 Mortgages, notes, bonds payable in 1 year or more				
21 Other liabilities (attach schedule)				
22 Capital stock				100.
23 Additional paid-in capital				14,910,701.
24 Retained earnings				-13,353,162.
25 Adjustments to shareholders' equity (attach schedule)				
26 Less cost of treasury stock		( )		( )
27 Total liabilities and shareholders' equity				1,557,639.

Schedule M-1 **Reconciliation of Income (Loss) per Books With Income (Loss) per Return** (You are not required to complete this schedule if the total assets on line 15, column (d), of Schedule L are less than $25,000.)

1 Net income (loss) per books	-13,353,162.	5 Income recorded on books this year not included on Schedule K, lines 1 through 6 (itemize)	
2 Income included on Schedule K, lines 1 through 6, not recorded on books this year (itemize)		a Tax-exempt interest	
3 Expenses recorded on books this year not included on Schedule K, lines 1 through 11a, 15e, and 16b (itemize)		6 Deductions included on Schedule K, lines 1 through 11a, 15e, and 16b, not charged against book income this year (itemize)	
a Depreciation		a Depreciation	
b Travel and entertainment			
		7 Add lines 5 and 6	
		8 Income (loss) (Schedule K, line 23). Line 4 less line 7	-13,353,162.
4 Add lines 1 through 3	-13,353,162.		

Schedule M-2 **Analysis of Accumulated Adjustments Account, Other Adjustments Account, and Shareholders' Undistributed Taxable Income Previously Taxed** (see page 24 of the instructions)

	(a) Accumulated adjustments account	(b) Other adjustments account	(c) Shareholders undistributed taxable income previously taxed
1 Balance at beginning of tax year			
2 Ordinary income from page 1, line 21			
3 Other additions			
4 Loss from page 1, line 21	(13,353,162.)		
5 Other reductions	( )	( )	
6 Combine lines 1 through 5	-13,353,162.		
7 Distributions other than dividend distributions			
8 Balance at end of tax year. Subtract line 7 from line 6	-13,353,162.		

Form **4797**

Department of the Treasury
Internal Revenue Service (99)

Sales of Business Property
(Also Involuntary Conversions and Recapture Amounts Under Sections 179 and 280F(b)(2))

▶ Attach to your tax return. ▶ See separate instructions.

OMB No. 1545-0184

1999

Attachment Sequence No. **27**

Name(s) shown on return

Identifying number

TESORO DRIVE INVESTORS, INC. | 74-2936191

1 Enter here the gross proceeds from the sale or exchange of real estate reported to you for 1999 on Form(s) 1099-S (or a substitute statement) that you will be including on line 2, 10, or 20 1

Part I Sales or Exchanges of Property Used in a Trade or Business and Involuntary Conversions From Other Than Casualty or Theft - Property Held More Than 1 Year

(a) Description of property	(b) Date acquired (mo., day, yr.)	(c) Date sold (mo., day, yr.)	(d) Gross sales price	(e) Depreciation allowed or allowable since acquisition	(f) Cost or other basis, plus improvements and expense of sale	(g) GAIN or (LOSS) Subtract (f) from the sum of (d) and (e)
2						

3	Gain, if any, from Form 4684, line 39	3
4	Section 1231 gain from installment sales from Form 6252, line 26 or 37	4
5	Section 1231 gain or (loss) from like-kind exchanges from Form 8824	5
6	Gain, if any, from line 32, from other than casualty or theft	6
7	Combine lines 2 through 6. Enter gain or (loss) here and on the appropriate line as follows	7

Partnerships (except electing large partnerships). Report the gain or (loss) following the instructions for Form 1065, Schedule K, line 6. Skip lines 8, 9, 11, and 12 below.

S corporations. Report the gain or (loss) following the instructions for Form 1120S, Schedule K, lines 5 and 6. Skip lines 8, 9, 11, and 12 below, unless line 7 is a gain and the S corporation is subject to the capital gains tax.

All others. If line 7 is zero or a loss, enter the amount from line 7 on line 11 below and skip lines 8 and 9. If line 7 is a gain and you did not have any prior year section 1231 losses, or they were recaptured in an earlier year, enter the gain from line 7 as a long-term capital gain on Schedule D and skip lines 8, 9, and 12 below.

8	Nonrecaptured net section 1231 losses from prior years (see instructions)	8
9	Subtract line 8 from line 7. If zero or less, enter -0-. Also enter on the appropriate line as follows (see instructions)	9

S corporations. Enter any gain from line 9 on Schedule D (form 1120S), line 14, and skip lines 11 and 12 below.

All others. If line 9 is zero, enter the gain from line 7 on line 12 below. If line 9 is more than zero, enter the amount from line 8 on line 12 below, and enter the gain from line 9 as a long-term capital gain on Schedule D.

Part II Ordinary Gains and Losses

10 Ordinary gains and losses not included on lines 11 through 17 (include property held 1 year or less):

STMT 1						-13,353,162.

11	Loss, if any, from line 7	11	( )
12	Gain, if any, from line 7 or amount from line 8, if applicable	12	
13	Gain, if any, from line 31	13	
14	Net gain or (loss) from Form 4684, lines 31 and 38a	14	
15	Ordinary gain from installment sales from Form 6252, line 25 or 36	15	
16	Ordinary gain or (loss) from like-kind exchanges from Form 8824	16	
17	Recapture of section 179 expense deduction for partners and S corporation shareholders from property dispositions by partnerships and S corporations (see instructions)	17	
18	Combine lines 10 through 17. Enter the gain or (loss) here, and on the appropriate line as follows	18	-13,353,162.
a	For all except individual returns: Enter the gain or (loss) from line 18 on the return being filed.		
b	For individual returns:		
(1)	If the loss on line 11 includes a loss from Form 4684, line 35, column (b)(ii), enter that part of the loss here. Enter the part of the loss from income producing property on Schedule A (Form 1040), line 27, and the part of the loss from property used as an employee on Schedule A (Form 1040), line 22. Identify as from "Form 4797, line 18b(1)." See instructions.	18b(1)	
(2)	Redetermine the gain or (loss) on line 18, excluding the loss, if any, on line 18b(1). Enter here and on Form 1040, line 14.	18b(2)	

For Paperwork Reduction Act Notice, see separate instructions. Form **4797** (1999)

JSA

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Part III **Gain From Disposition of Property Under Sections 1245, 1250, 1252, 1254, and 1255**

19 (a) Description of section 1245, 1250, 1252, 1254, or 1255 property	(b) Date acquired (mo., day, yr.)	(c) Date sold (mo., day, yr.)
A		
B		
C		
D		

These columns relate to the properties on lines 19A through 19D ▶		Property A	Property B	Property C	Property D
20 Gross sales price (Note: *See line 1 before completing.*)	20				
21 Cost or other basis plus expense of sale	21				
22 Depreciation (or depletion) allowed or allowable	22				
23 Adjusted basis. Subtract line 22 from line 21	23				
24 Total gain. Subtract line 23 from line 20	24				
25 If section 1245 property:					
a Depreciation allowed or allowable from line 22	25a				
b Enter the smaller of line 24 or 25a	25b				
26 If section 1250 property: If straight line depreciation was used, enter -0- on line 26g, except for a corporation subject to section 291.					
a Additional depreciation after 1975 (see instructions)	26a				
b Applicable percentage multiplied by the smaller of line 24 or line 26a (see instructions)	26b				
c Subtract line 26a from line 24. If residential rental property or line 24 is not more than line 26a, skip lines 26d and 26e	26c				
d Additional depreciation after 1969 and before 1976	26d				
e Enter the smaller of line 26c or 26d	26e				
f Section 291 amount (corporations only)	26f				
g Add lines 26b, 26e, and 26f	26g				
27 If section 1252 property: Skip this section if you did not dispose of farmland or if this form is being completed for a partnership (other than an electing large partnership).					
a Soil, water, and land clearing expenses	27a				
b Line 27a multiplied by applicable percentage (see instructions)	27b				
c Enter the smaller of line 24 or 27b	27c				
28 If section 1254 property:					
a Intangible drilling and development costs, expenditures for development of mines and other natural deposits, and mining exploration costs (see instructions)	28a				
b Enter the smaller of line 24 or 28a	28b				
29 If section 1255 property:					
a Applicable percentage of payments excluded from income under section 126 (see instructions)	29a				
b Enter the smaller of line 24 or 29a (see instructions)	29b				

Summary of Part III Gains. Complete property columns A through D through line 29b before going to line 30.

30 Total gains for all properties. Add property columns A through D, line 24	30	
31 Add property columns A through D, lines 25b, 26g, 27c, 28b, and 29b. Enter here and on line 13	31	
32 Subtract line 31 from line 30. Enter the portion from casualty or theft on Form 4684, line 33. Enter the portion from other than casualty or theft on Form 4797, line 6	32	

Part IV **Recapture Amounts Under Sections 179 and 280F(b)(2) When Business Use Drops to 50% or Less**
See instructions.

		(a) Section 179	(b) Section 280F(b)(2)
33 Section 179 expense deduction or depreciation allowable in prior years	33		
34 Recomputed depreciation. See instructions	34		
35 Recapture amount. Subtract line 34 from line 33. See the instructions for where to report	35		

TESORO DRIVE INVESTORS, INC. 74-2936191

FORM 4797, PAGE 1 DETAIL PART II

(A) DESCRIPTION OF PROPERTY	(B) DATE ACQUIRED	(C) DATE SOLD	(D) GROSS SALES PRICE	(E) DEPREC. ALLOWED	(F) COST OR OTHER BASIS PLUS IMPROV AND SALE EXPENSE	(G) GAIN/LOSS
CURRENCY CONTRACT	12/23/99	12/30/99	251,838.		13605000.	-13353162.
PART II 4797 ORDINARY GAINS AND LOSSES						-13353162.

SHAREHOLDER SUMMARY

SH. #	SHAREHOLDER NAME	BEGINNING SHARES	OWNERSHIP PERCENTAGE
1	BILLY MCCOMBS	38.4600	38.460000
2	GARY WOODS	61.5400	61.540000

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SCHEDULE K-1 (Form 1120S)	Shareholder's Share of Income, Credits, Deductions, etc.	OMB No 1545-0130
Department of the Treasury Internal Revenue Service	▶ See separate instructions. For calendar year 1999 or tax year beginning 11/12, 1999, and ending 12/31, 1999	1999

Shareholder's identifying number ▶ 467-26-3574	Corporation's identifying number ▶ 74-2936191
Shareholder's name, address, and ZIP code	Corporation's name, address, and ZIP code
BILLY MCCOMBS 9000 TESORO DRIVE SUITE 122 SAN ANTONIO, TX 78217	TESORO DRIVE INVESTORS, INC. 9000 TESORO DRIVE, SUITE 122 SAN ANTONIO TX 78217

A Shareholder's percentage of stock ownership for tax year (see instructions for Schedule K-1) . . . . . ▶ 38.460000 %

B Internal Revenue Service Center where corporation filed its return ▶ AUSTIN, TX 73301

C Tax shelter registration number (see instructions for Schedule K-1) . . . . . ▶

D Check applicable boxes: (1) ☐ Final K-1 (2) ☐ Amended K-1

	(a) Pro rata share items		(b) Amount	(c) Form 1040 filers enter the amount in column (b) on
Income (Loss)	1 Ordinary income (loss) from trade or business activities	1	-5,135,626.	See pages 4 and 5 of the Shareholder's Instructions for Schedule K-1 (Form 1120S)
	2 Net income (loss) from rental real estate activities	2		
	3 Net income (loss) from other rental activities	3		
	4 Portfolio income (loss):			
	a Interest	4a		Sch B, Part I, line 1
	b Ordinary dividends	4b		Sch B, Part II, line 5
	c Royalties	4c		Sch E, Part I, line 4
	d Net short-term capital gain (loss)	4d		Sch D, line 5, col (f)
	e Net long-term capital gain (loss):			
	(1) 28% rate gain (loss)	e(1)		Sch D, line 12, col (g)
	(2) Total for year	e(2)		Sch D, line 12, col (f)
	f Other portfolio income (loss) (attach schedule)	4f		(Enter on applicable line of your return.)
	5 Net section 1231 gain (loss) (other than due to casualty or theft)	5		See Shareholder's Instructions for Schedule K-1 (Form 1120S)
	6 Other income (loss) (attach schedule)	6		(Enter on applicable line of your return.)
Deductions	7 Charitable contributions (attach schedule)	7		Sch A, line 15 or 16
	8 Section 179 expense deduction	8		See page 6 of the Shareholder's Instructions for Schedule K-1 (Form 1120S)
	9 Deductions related to portfolio income (loss) (attach schedule)	9		
	10 Other deductions (attach schedule)	10		
Investment Interest	11a Interest expense on investment debts	11a		Form 4952, line 1
	b (1) Investment income included on lines 4a, 4b, 4c, and 4f above	b(1)		See Shareholder's Instructions for Schedule K-1 (Form 1120S)
	(2) Investment expenses included on line 9 above	b(2)		
Credits	12a Credit for alcohol used as fuel	12a		Form 6478, line 10
	b Low-income housing credit:			
	(1) From section 42(j)(5) partnerships for property placed in service before 1990	b(1)		Form 8586, line 5
	(2) Other than on line 12b(1) for property placed in service before 1990	b(2)		
	(3) From section 42(j)(5) partnerships for property placed in service after 1989	b(3)		
	(4) Other than on line 12b(3) for property placed in service after 1989	b(4)		
	c Qualified rehabilitation expenditures related to rental real estate activities	12c		See page 7 of the Shareholder's Instructions for Schedule K-1 (Form 1120S)
	d Credits (other than credits shown on lines 12b and 12c) related to rental real estate activities	12d		
	e Credits related to other rental activities	12e		
	13 Other credits	13		

	(a) Pro rata share items		(b) Amount	(c) Form 1040 lines enter the amount in column (b) on
Adjustments and Tax Preference Items	14a Depreciation adjustment on property placed in service after 1986	14a		See page 7 of the Shareholder's Instructions for Schedule K-1 (Form 1120S) and Instructions for Form 6251
	b Adjusted gain or loss	14b		
	c Depletion (other than oil and gas)	14c		
	d (1) Gross income from oil, gas, or geothermal properties	d(1)		
	(2) Deductions allocable to oil, gas, or geothermal properties	d(2)		
	e Other adjustments and tax preference items (attach schedule)	14e		
Foreign Taxes	15a Type of income ▶			Form 1116, Check boxes
	b Name of foreign country or U.S. possession ▶			
	c Total gross income from sources outside the United States (attach schedule)	15c		Form 1116, Part I
	d Total applicable deductions and losses (attach schedule)	15d		
	e Total foreign taxes (check one) ▶ ☐ Paid ☐ Accrued	15e		Form 1116, Part II
	f Reduction in taxes available for credit (attach schedule)	15f		Form 1116, Part III
	g Other foreign tax information (attach schedule)	15g		See instructions for Form 1116
Other	16 Section 59(e)(2) expenditures a Type ▶			See Shareholder's Instructions for Schedule K-1 (Form 1120S)
	b Amount	16b		
	17 Tax-exempt interest income	17		Form 1040, line 8b
	18 Other tax-exempt income	18		See page 7 and 8 of the Shareholder's Instructions for Schedule K-1 (Form 1120S)
	19 Nondeductible expenses	19		
	20 Property distributions (including cash) other than dividend distributions reported to you on Form 1099-DIV	20		
	21 Amount of loan repayments for "Loans From Shareholders"	21		
	22 Recapture of low-income housing credit:			
	a From section 42(j)(5) partnerships	22a		Form 8611, line 8
	b Other than on line 22a	22b		

Supplemental Information

23 Supplemental information required to be reported separately to each shareholder (attach additional schedules if more space is needed)

SCHEDULE K-1 (Form 1120S)

Department of the Treasury Internal Revenue Service

Shareholder's Share of Income, Credits, Deductions, etc.

▶ See separate instructions.

For calendar year 1999 or tax year beginning 11/12, 1999, and ending 12/31,1999

OMB No 1545-0130

1999

Shareholder's identifying number ▶ 463-60-1990	Corporation's identifying number ▶ 74-2936191
Shareholder's name, address, and ZIP code	Corporation's name, address, and ZIP code
GARY WOODS 9000 TESORO DRIVE SUITE 122 SAN ANTONIO, TX 78217	TESORO DRIVE INVESTORS, INC. 9000 TESORO DRIVE, SUITE 122 SAN ANTONIO TX 78217

A Shareholder's percentage of stock ownership for tax year (see instructions for Schedule K-1) . . . . . ▶ 61.540000 %

B Internal Revenue Service Center where corporation filed its return ▶ AUSTIN, TX 73301

C Tax shelter registration number (see instructions for Schedule K-1) . . . . . ▶

D Check applicable boxes (1) ☐ Final K-1 (2) ☐ Amended K-1

	(a) Pro rata share items		(b) Amount	(c) Form 1040 filers enter the amount in column (b) on
Income (Loss)	1 Ordinary income (loss) from trade or business activities	1	-8,217,536.	See pages 4 and 5 of the Shareholder's Instructions for Schedule K-1 (Form 1120S)
	2 Net income (loss) from rental real estate activities	2		
	3 Net income (loss) from other rental activities	3		
	4 Portfolio income (loss)			
	a Interest	4a		Sch B, Part I, line 1
	b Ordinary dividends	4b		Sch B, Part II, line 5
	c Royalties	4c		Sch E, Part I, line 4
	d Net short-term capital gain (loss)	4d		Sch D, line 5, col (f)
	e Net long-term capital gain (loss)			
	(1) 28% rate gain (loss)	e(1)		Sch D, line 12, col (g)
	(2) Total for year	e(2)		Sch D, line 12, col (f)
	f Other portfolio income (loss) (attach schedule)	4f		(Enter on applicable line of your return.)
	5 Net section 1231 gain (loss) (other than due to casualty or theft)	5		See Shareholder's Instructions for Schedule K-1 (Form 1120S)
	6 Other income (loss) (attach schedule)	6		(Enter on applicable line of your return.)
Deductions	7 Charitable contributions (attach schedule)	7		Sch A, line 15 or 16
	8 Section 179 expense deduction	8		See page 6 of the Shareholder's Instructions for Schedule K-1 (Form 1120S)
	9 Deductions related to portfolio income (loss) (attach schedule)	9		
	10 Other deductions (attach schedule)	10		
Investment Interest	11a Interest expense on investment debts	11a		Form 4952, line 1
	b (1) Investment income included on lines 4a, 4b, 4c, and 4f above	b(1)		See Shareholder's Instructions for Schedule K-1 (Form 1120S)
	(2) Investment expenses included on line 9 above	b(2)		
Credits	12a Credit for alcohol used as fuel	12a		Form 6478, line 10
	b Low-income housing credit			
	(1) From section 42(j)(5) partnerships for property placed in service before 1990	b(1)		Form 8586, line 5
	(2) Other than on line 12b(1) for property placed in service before 1990	b(2)		
	(3) From section 42(j)(5) partnerships for property placed in service after 1989	b(3)		
	(4) Other than on line 12b(3) for property placed in service after 1989	b(4)		
	c Qualified rehabilitation expenditures related to rental real estate activities	12c		See page 7 of the Shareholder's Instructions for Schedule K-1 (Form 1120S)
	d Credits (other than credits shown on lines 12b and 12c) related to rental real estate activities	12d		
	e Credits related to other rental activities	12e		
	13 Other credits	13		

For Paperwork Reduction Act Notice, see the Instructions for Form 1120S. Schedule K-1 (Form 1120S) 1999

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	(a) Pro rata share items		(b) Amount	(c) Form 1040 filers enter the amount in column (b) on
Adjustments and Tax Preference Items	14a Depreciation adjustment on property placed in service after 1986	14a		See page 7 of the Shareholder's Instructions for Schedule K-1 (Form 1120S) and Instructions for Form 6251
	b Adjusted gain or loss	14b		
	c Depletion (other than oil and gas)	14c		
	d (1) Gross income from oil, gas, or geothermal properties	d(1)		
	(2) Deductions allocable to oil, gas, or geothermal properties	d(2)		
	e Other adjustments and tax preference items (attach schedule)	14e		
Foreign Taxes	15a Type of income ▶			Form 1116, Check boxes
	b Name of foreign country or U.S. possession ▶			
	c Total gross income from sources outside the United States (attach schedule)	15c		Form 1116, Part I
	d Total applicable deductions and losses (attach schedule)	15d		
	e Total foreign taxes (check one) ▶ ☐ Paid ☐ Accrued	15e		Form 1116, Part II
	f Reduction in taxes available for credit (attach schedule)	15f		Form 1116, Part III
	g Other foreign tax information (attach schedule)	15g		See Instructions for Form 1116
Other	16 Section 59(e)(2) expenditures a Type ▶			See Shareholder's Instructions for Schedule K-1 (Form 1120S)
	b Amount	16b		
	17 Tax-exempt interest income	17		Form 1040, line 8b
	18 Other tax-exempt income	18		See page 7 and 8 of the Shareholder's Instructions for Schedule K-1 (Form 1120S)
	19 Nondeductible expenses	19		
	20 Property distributions (including cash) other than dividend distributions reported to you on Form 1099-DIV	20		
	21 Amount of loan repayments for "Loans From Shareholders"	21		
	22 Recapture of low income housing credit			
	a From section 42(j)(5) partnerships	22a		Form 8611, line 8
	b Other than on line 22a	22b		

Supplemental Information

23 Supplemental information required to be reported separately to each shareholder *(attach additional schedules if more space is needed)*

(221)

TESORO DRIVE INVESTORS, INC.
E.I.N. 74-2936191
FORM 1120S, FYE 12/31/99

TRANSFEREE CORPORATION'S STATEMENT
UNDER REGULATION IRC SEC. 1.351-3(b)

(1) & (2) Property received and adjusted basis of that property to transferor - On December 27, 1999, transferee, in exchange for the consideration set out in paragraph (3) et. seq. of this statement, received the property listed below. The adjusted basis of each item of property to the transferor as of the date of the transfer is set out in the column entitled, "Tax Basis"

(a) From Billy J. McCombs:

Property	Tax Basis
Partnership interest in Tesoro Drive Investment Partners	$5,481,062

From Gary Woods:

Property	Tax Basis
Partnership interest in Tesoro Drive Investment Partners	$8,769,739

The property above is listed in detail in the transferee's permanent books of account.

(3) Information about transferee's capital stock:

(i) Total issued and outstanding capital stock of transferee immediately before and immediately after the exchange.

Class of stock	No. of share outstanding immediately before exchange	No. of shares outstanding immediately after exchange
Common	None	100

(ii) Immediately after the exchange, the transferors owned 100 of the 100 shares issued of transferee's common stock and, therefore, 100% of the outstanding shares. Ownership of stock is as follows:

Billy J. McCombs	38.46 shares
Gary Woods	61.54 shares

(iii) Fair market value of shares issued in exchange - Each share of common stock issued in the exchange had a fair market value of $1 per share.

(4) Information about the transferee's securities: The transferee issued no securities and had no securities outstanding immediately before or after the exchange.

(5) Money paid to transferor in connection with the exchange: No money passed to the transferor.

(6) Other property given to transferor in connection with the exchange: No property other than common stock with fair market value of $100 was passed to the transferor in connection with this exchange.

(7) Liabilities of transferor assumed by transferee in connection with exchange: The transferee did not assume any liabilities in connection with this exchange.

PETITIONER'S BRIEF

RECORD
AND
BRIEFS

SUPREME COURT, U.S.
FILED
MAY 30 2013
OFFICE OF THE CLERK

No. 12-562

In the Supreme Court of the United States

UNITED STATES OF AMERICA, PETITIONER

v.

GARY WOODS, AS TAX MATTERS PARTNER OF TESORO DRIVE PARTNERS, ET AL.

ON WRIT OF CERTIORARI
TO THE UNITED STATES COURT OF APPEALS
FOR THE FIFTH CIRCUIT

BRIEF FOR THE UNITED STATES

DONALD B. VERRILLI, JR.
Solicitor General
Counsel of Record
KATHRYN KENEALLY
Assistant Attorney General
MALCOLM L. STEWART
Deputy Solicitor General
JOHN F. BASH
Assistant to the Solicitor General
GILBERT S. ROTHENBERG
RICHARD FARBER
ARTHUR T. CATTERALL
Attorneys

Department of Justice
Washington, D.C. 20530-0001
SupremeCtBriefs@usdoj.gov
(202) 514-2217

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QUESTIONS PRESENTED

Section 6226 of the Internal Revenue Code confers jurisdiction on a district court to review the Internal Revenue Service's audit of a partnership's return and "to determine * * * the applicability of any penalty * * * which relates to an adjustment to a partnership item." 26 U.S.C. 6226(f). Section 6662 of the Code imposes a penalty for an underpayment of federal income tax that is "attributable to" a "substantial valuation misstatement," and the term "substantial valuation misstatement" is defined to include a substantial overstatement of adjusted basis in property. See 26 U.S.C. 6662(a), (b)(3), (e)(1)(A) and (h)(1). The questions presented are as follows:

1. Whether the district court had jurisdiction in this case under 26 U.S.C. 6226 to consider the substantial valuation misstatement penalty.

2. Whether the overstatement penalty applies to an underpayment of tax resulting from a determination that a transaction lacks economic substance because the sole purpose of the transaction was to generate a tax loss by artificially inflating the taxpayer's basis in property.

PARTIES TO THE PROCEEDINGS

Petitioner is the United States of America.

Respondent is Gary Woods, as Tax Matters Partner of Tesoro Drive Partners and SA Tesoro Investment Partners.

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In the Supreme Court of the United States

No. 12-562

UNITED STATES OF AMERICA, PETITIONER

v.

GARY WOODS, AS TAX MATTERS PARTNER OF TESORO DRIVE PARTNERS, ET AL.

ON WRIT OF CERTIORARI
TO THE UNITED STATES COURT OF APPEALS
FOR THE FIFTH CIRCUIT

BRIEF FOR THE UNITED STATES

OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1a-2a) is not published in the *Federal Reporter* but is reprinted in 471 Fed. Appx. 320. The opinions of the district court (Pet. App. 3a-14a, 15a-22a) are reported at 794 F. Supp. 2d 714 and 794 F. Supp. 2d 710.

JURISDICTION

The judgment of the court of appeals was entered on June 6, 2012. A petition for rehearing was denied on August 8, 2012 (Pet. App. 23a-24a). The petition for a writ of certiorari was filed on November 6, 2012. The petition was granted on March 25, 2013. The jurisdiction of this Court rests on 28 U.S.C. 1254(1).

STATUTORY AND REGULATORY PROVISIONS INVOLVED

The pertinent statutory and regulatory provisions are reproduced in the appendix to this brief. App., *infra*, 1a-64a.

STATEMENT

This case concerns a penalty that the Internal Revenue Service (IRS) assesses when a taxpayer overstates his basis in property on an income-tax return in a way that results in an underpayment of tax. 26 U.S.C. 6662(a), (b)(3), (e)(1)(A) and (h)(1). The overstatement in this case arose from an abusive tax shelter in which two taxpayers used sham partnerships to create the illusion that they had very high bases in certain assets. They then used the high basis figures to claim tax deductions of tens of millions of dollars.

The IRS concluded, under the "economic substance" doctrine, that the partnerships and the transactions must be disregarded for tax purposes. It further found that the taxpayers were subject to the overstatement penalty for any underpayments of tax resulting from the scheme. On judicial review, the district court agreed that the transactions lacked economic substance, but held that the overstatement penalty was inapplicable as a matter of law, and the court of appeals affirmed. Pet. App. 1a-22a.

I. STATUTORY BACKGROUND

A. Section 6662's Basis-Overstatement Penalty

1. The Internal Revenue Code, "relying as it does upon self-assessment and reporting," *United States* v. *Arthur Young & Co.*, 465 U.S. 805, 815 (1984), requires taxpayers to file returns indicating the amount of income tax they owe. 26 U.S.C. 6011(a), 6012(a). If the

IRS determines that an individual's return understates his tax liability, it generally must send a notice of deficiency to the taxpayer indicating the amount owed. 26 U.S.C. 6211-6212. The taxpayer may challenge the deficiency determination in the United States Tax Court before the IRS may assess the deficiency. 26 U.S.C. 6213(a).

In reviewing returns, the IRS also determines the applicability of any penalties set forth in Section 6662 for certain inaccuracies on a return that result in the underpayment of tax, such as when a taxpayer substantially understates the amount of income tax owed or negligently fails to comply with provisions of the Code. See 26 U.S.C. 6662.[1] As relevant here, Section 6662 imposes a penalty if a taxpayer overstates her basis in property on a return in a way that results in an underpayment of tax. 26 U.S.C. 6662(a), (b)(3) and (e). The term "basis" refers to "a taxpayer's capital stake in an asset for tax purposes," *Washington Mut. Inc.* v. *United States*, 636 F.3d 1207, 1217 (9th Cir. 2011), and in practice it is often equal to the price the taxpayer paid for the asset (*e.g.*, stock). As a general matter, a taxpayer determines her gain or loss on the sale of an asset by subtracting the basis from the sale price; a positive figure is a gain while a negative figure is a loss. See 26 U.S.C. 1001(a). Thus, a taxpayer who overstates her basis in a sold asset on a return will understate the gain

---

[1] Unless otherwise indicated, all citations to 26 U.S.C. 6662 are to that provision as it appears in the 2000 edition of the United States Code. A number of the regulations cited in this brief replaced temporary regulations that were in effect until October 2001. Because the regulations are materially identical, this brief cites the more readily accessible current regulations.

(or overstate the loss) from the sale, which often results in an underpayment of income tax.

To deter such basis overstatements, Section 6662 provides that, when a taxpayer is determined to have underpaid her tax, "there shall be added to the [income] tax [owed] an amount equal to 20 percent of the portion of the underpayment * * * which is attributable to * * * [a]ny substantial valuation misstatement." 26 U.S.C. 6662(a) and (b)(3). A taxpayer commits a "substantial valuation misstatement" if, *inter alia*, "the adjusted basis of any property[] claimed on any [income-tax return] is 200 percent or more of the amount determined to be the correct amount of such * * * adjusted basis." 26 U.S.C. 6662(e)(1)(A). No penalty is imposed, however, unless the underpayment exceeds $5000. 26 U.S.C. 6662(e)(2).

Section 6662 imposes a greater penalty for a "gross valuation misstatement[ ]," defined to include an overstatement of the adjusted basis of property that is 400% or more of the correct amount. 26 U.S.C. 6662(h)(2)(A)(i).[2] "To the extent that a portion of the underpayment [of income tax] is attributable to one or more gross valuation misstatements," a penalty equal to 40% of that portion of the underpayment is imposed on the taxpayer. 26 U.S.C. 6662(h)(1). Even if a single underpayment might otherwise trigger multiple penalties, the largest penalty amount that can be imposed is 40% of the underpayment. See 26 U.S.C. 6662(b); 26 C.F.R. 1.6662-2(c).

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[2] Section 6662 was amended in 2006 to lower the threshold for a substantial valuation misstatement to 150% (26 U.S.C. 6662(e)(1)(A)) and the threshold for a gross valuation misstatement to 200% (26 U.S.C. 6662(h)(2)(A)(i))). See Pension Protection Act of 2006, Pub. L. No. 109-280, § 1219(a)(1) and (2), 120 Stat. 1083.

2. Under Section 6662, cases may arise in which part of a taxpayer's underpayment of tax is "attributable to" an overstatement of basis, while the remainder of the underpayment is attributable to other errors (for example, failing to include all taxable income or taking an inapplicable deduction). In those circumstances, it is necessary to identify the "portion" of the underpayment of tax that is "attributable to" the basis overstatement.

After the passage of the Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, 95 Stat. 172, which added the predecessor to the overstatement penalty of Section 6662,[3] the staff of Congress's Joint Committee on Taxation produced a summary of the legislation known as the *Blue Book*. See Staff of the Joint Comm. on Taxation, 97th Cong., *General Explanation of the Economic Recovery Tax Act of 1981* (Comm. Print 1981) (*Blue Book*). The *Blue Book* stated that "[t]he portion of a tax underpayment that is attributable to a valuation overstatement will be determined after taking into account any other proper adjustments to tax liability." *Id.* at 333. It

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[3] The predecessor to the overstatement penalty was located at 26 U.S.C. 6659 and provided a schedule of penalties for "an underpayment of [income tax] for the taxable year which is attributable to a valuation overstatement." 26 U.S.C. 6659(a) (1988). A "valuation overstatement" was in turn defined to exist "if * * * the adjusted basis of any property[ ] claimed on any return is 150 percent or more of the amount determined to be the correct amount of such * * * adjusted basis." 26 U.S.C. 6659(c) (1988). Section 6662 was enacted in 1989 to replace Section 6659 (and other penalty provisions). See Improved Penalty Administration and Compliance Tax Act, Pub. L. No. 101-239, § 7721(a) and (c)(2), 103 Stat. 2395, 2399. The principal purpose of the change was to "improve the fairness, comprehensibility, and administrability of the[ ] penalties" by consolidating a number of penalty provisions in one section. H.R. Rep. No. 247, 101st Cong., 1st Sess. 1388 (1989).

then set forth a formula to calculate the appropriate portion:

> [T]he underpayment resulting from a valuation overstatement will be determined by comparing the taxpayer's (1) actual tax liability (i.e., the tax liability that results from a proper valuation and which takes into account any other proper adjustments) with (2) actual tax liability as reduced by taking into account the valuation overstatement. The difference between these two amounts will be the underpayment that is attributable to the valuation overstatement.

Ibid. An almost identical explanation appears in the legislative history of a similar penalty provision enacted in 1986. See H.R. Rep. No. 426, 99th Cong., 1st Sess. 763 (1985).

To illustrate the application of this formula, the *Blue Book* included the following example:

> Assume that in 1982 an individual files a joint return showing taxable income of $40,000 and tax liability of $9,195. Assume, further, that a $30,000 deduction which was claimed by the taxpayer as the result of a valuation overstatement is adjusted down to $10,000, and that another deduction of $20,000 is disallowed totally for reasons apart from the valuation overstatement. These adjustments result in correct taxable income of $80,000 and correct tax liability of $27,505. Accordingly, the underpayment due to the valuation overstatement is the difference between the tax on $80,000 ($27,505) and the tax on $60,000 ($17,505) (i.e., actual tax liability reduced by taking into account the deductions disallowed because of the valuation overstatement), or $9,800.

Id. at 333 n.2.[4]

3. In 1991, the Department of the Treasury (Treasury) promulgated a regulation addressing various issues with respect to the overstatement penalty. See 26 C.F.R. 1.6662-5. Subsection (g) of that regulation provides that when the correct basis of property is zero—and thus the overstatement percentage technically would be infinite or undefined—any overstatement of basis is a gross valuation misstatement. 26 C.F.R. 1.6662-5(g). The regulation also clarifies that the $5000 minimum underpayment necessary to trigger the penalties applies to both substantial and gross valuation misstatements. See 26 C.F.R. 1.6662-5(b).

B. Procedures For Auditing Partnership Returns And Imposing Penalties

1. As "pass through" entities, partnerships do not pay federal income tax. 26 U.S.C. 701. Rather, tax on a partnership's income is paid by individual partners, who must account on their own tax returns for their distributive shares of the partnership's income and losses. 26 U.S.C. 701, 702(a); see *United States* v. *Basye*, 410 U.S. 441, 448 (1973). A partnership, however, must file an information return every year "stating specifically the items of its gross income and [any allowable] deductions," and identifying the "individuals who would be entitled to share in the taxable income if distributed and the amount of the distributive share of each individual." 26 U.S.C. 6031(a).

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[4] In what appears to have been a mathematical error, the *Blue Book* example incorrectly calculated the underpayment attributable to the valuation overstatement to be $9800 rather than $10,000 (*i.e.*, $27,505 minus $17,505).

Before 1982, if the IRS believed that a partnership's return was inaccurate, it was required to issue separate notices of deficiency to all partners, each of whom could independently challenge his notice in the Tax Court. That approach often resulted in duplicative proceedings and inconsistent treatment of partnership income among different partners, and it required the IRS to enter into separate settlements with each partner. See *Callaway* v. *Commissioner*, 231 F.3d 106, 107-108 (2d Cir. 2000). To remedy those problems, Section 402 of the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), Pub. L. No. 97-248, 96 Stat. 324, established unified procedures through which the IRS determines partnership-level tax issues for all partners at once and courts then review the IRS's conclusions. See § 402, 96 Stat. 648-667; 26 U.S.C. 6221-6234.

TEFRA requires the IRS to determine "the tax treatment of any partnership item" in a proceeding "at the partnership level"—*i.e.*, through an audit of the partnership's return. 26 U.S.C. 6221. TEFRA further requires that each partner, on his own tax return, must "treat a partnership item in a manner which is consistent with the treatment of such partnership item on the partnership return," 26 U.S.C. 6222(a), or else notify the IRS of any inconsistency between the two returns, 26 U.S.C. 6222(b)(1). The statute defines a "partnership item" as "any item required to be taken into account for the partnership's taxable year under any [income tax] provision" that, as provided in regulations, "is more appropriately determined at the partnership level than at the partner level." 26 U.S.C. 6231(a)(3). In accordance with the statute, the Treasury has defined the term "partnership item" by regulation to include "[t]he partnership aggregate and each partner's share of * * *

[i]tems of income, gain, loss, deduction, or credit of the partnership," as well as certain "[i]tems relating to * * * [c]ontributions to the partnership" and "[d]istributions from the partnership." 26 C.F.R. 301.6231(a)(3)-1(a)(1)(i), (a)(4)(i) and (ii). The regulation further provides that "[t]he term 'partnership item' includes the accounting practices and the legal and factual determinations that underlie the determination of the amount, timing, and characterization of items of income, credit, gain, loss, deduction, etc." 26 C.F.R. 301.6231(a)(3)-1(b).

Under TEFRA, the IRS may initiate an administrative proceeding to audit a partnership's information return by sending notice to certain specified partners. 26 U.S.C. 6223(a). Any partner may participate in that proceeding. 26 U.S.C. 6224(a). If the IRS concludes that adjustments to partnership items are necessary, it must issue a Notice of Final Partnership Administrative Adjustment (FPAA) setting forth the changes. See 26 U.S.C. 6223(a)(2), 6225(a).

The partners then may challenge the FPAA in court. TEFRA authorizes certain partners to file a petition for readjustment in the Tax Court, the Court of Federal Claims, or a federal district court. 26 U.S.C. 6226(a) and (b), 6231(a)(7), (8) and (11). All partners with an interest in the outcome are parties to the action and may participate in the proceedings. 26 U.S.C. 6226(c) and (d). The partnership as an entity, however, is not a party to the suit; rather, "[t]he partnership proceeding contemplated by Congress is simply a conglomeration or aggregation of the[] affected partners." *Chef's Choice Produce, Ltd.* v. *Commissioner*, 95 T.C. 388, 395 (1990). The reviewing court in a TEFRA action has "jurisdiction to determine all partnership items of the partnership for the partner-

ship taxable year to which the [FPAA] relates." 26 U.S.C. 6226(f).

After the conclusion of administrative and judicial proceedings, the IRS computes the effect of the partnership-item adjustments on the tax liability of each partner. This change in tax liability is called a "computational adjustment." 26 U.S.C. 6230(c)(1)(A), 6231(a)(6); 26 C.F.R. 301.6231(a)(6)-1. As a general matter, a computational adjustment is immediately assessable against a partner without a notice of deficiency. See 26 U.S.C. 6230(a). For example, if an adjustment to the partnership's income requires a change to the distributive share of that income claimed on a partner's return, the IRS may immediately assess the additional tax liability. In that circumstance, an individual partner may file an administrative refund claim (and then may file suit if the claim is denied) if he believes that the IRS has committed an error in making the computational adjustment. 26 U.S.C. 6230(c)(1)(A) and (3). In a refund proceeding, however, "the treatment of partnership items * * * under the [FPAA], or under the decision of the court [in a partnership-level proceeding] (whichever is appropriate) [is] conclusive." 26 U.S.C. 6230(c)(4).

If the IRS makes a computational adjustment attributable to an "affected item"—*i.e.*, a non-partnership item that is affected by a partnership item, such as a deduction that varies with a partner's adjusted gross income—that adjustment is immediately assessable if it necessarily follows from the partnership-item adjustment, as in the case of a purely mathematical change to the partner's return. 26 U.S.C. 6230(a)(1) and (2)(A)(i), 6231(a)(5). If, however, the necessary changes require substantive "partner level determinations," the IRS

generally must follow the ordinary deficiency procedures. 26 U.S.C. 6230(a)(2)(A)(i); see *Duffie* v. *United States*, 600 F.3d 362, 385 (5th Cir.), cert. denied, 131 S. Ct. 355 (2010).

In addition to genuine partnerships, the TEFRA procedures apply to an entity that files a partnership return but is determined, for tax purposes, not to have been a partnership or not to have existed during the relevant tax year. 26 U.S.C. 6233; see 26 C.F.R. 301.6233-1.

2. Because partnerships do not pay tax, they are not subject to penalties for underpayment. Errors on a partnership return, however, may lead to the imposition of penalties against an individual partner if the partner prepares his own return in a manner consistent with the (inaccurate) partnership return and underpays his own taxes as a result. Penalties are not partnership items under TEFRA, but they can be affected items if they are imposed on a partner as the result of an adjustment to a partnership item. See 26 C.F.R. 301.6231(a)(5)-1(e); see also 26 U.S.C. 6230(a)(2)(A)(i). Penalties virtually always require further partner-level determinations. For that reason, under TEFRA as originally enacted, penalties could "only be asserted against a partner through the application of the deficiency procedures following the completion of the partnership-level proceeding." H.R. Conf. Rep. No. 220, 105th Cong., 1st Sess. 685 (1997) (1997 Conference Report); see *Tigers Eye Trading, LLC* v. *Commissioner*, 138 T.C. 67, 89 (2012).

In 1997, Congress recognized that "applying penalties at the partner level through the deficiency procedures following the conclusion of the unified proceeding at the partnership level increases the administrative burden on the IRS and can significantly increase the

Tax Court's inventory." H.R. Rep. No. 148, 105th Cong., 1st Sess. 594 (1997) (1997 House Report). Accordingly, in Section 1238 of the Taxpayer Relief Act of 1997, Pub. L. No. 105-34, 111 Stat. 1026-1027, Congress added provisions ensuring "that the partnership-level proceeding [would] include a determination of the applicability of penalties at the partnership level," while still "allow[ing] partners to raise any partner-level defenses in a refund forum." 1997 Conference Report 685.

The Taxpayer Relief Act provides that "the applicability of any penalty, addition to tax, or additional amount which relates to an adjustment to a partnership item[] shall be determined at the partnership level." 26 U.S.C. 6221. It likewise expands TEFRA's judicial-review provision to authorize a court to "determine * * * the applicability of any penalty, addition to tax, or additional amount which relates to an adjustment to a partnership item." 26 U.S.C. 6226(f). Thus, with respect both to partnership items themselves, and to any penalties related to adjustments to partnership items, Section 6226(f)'s delineation of a court's jurisdiction in partnership-level proceedings closely tracks the language of 26 U.S.C. 6221, which describes the determinations the IRS must make at the partnership level.

Since payment of taxes on partnership income is the responsibility of individual partners rather than of the partnership itself, neither the IRS nor a court can definitively resolve in partnership-level proceedings whether or on whom a penalty will ultimately be imposed. Rather, those determinations require a review of the returns of individual partners. If a particular partner did not owe any tax in a given year, for example, he would not be subject to Section 6662's accuracy-related penalties even if the partnership improperly claimed a loss on

its return. For that reason, in the partnership-level proceedings, the IRS and the court can make only the threshold determination that an adjustment to a partnership item corrects the sort of error that, if reflected in partners' individual returns, could trigger a penalty. See *Tigers Eye*, 138 T.C. at 142.

Once partnership-level proceedings conclude, the IRS evaluates partners' individual returns in light of the partnership-level adjustments. Unlike with other affected items requiring "partner level determinations," the IRS may assess penalties against individual partners immediately through computational adjustments without issuing a notice of deficiency. See 26 U.S.C. 6230(a)(2). A partner may then file a refund claim "to assert any partner level defenses that may apply or to challenge the amount of the computational adjustment." 26 U.S.C. 6230(c)(4). Again, however, any determination by the FPAA or by a court in a partnership-level proceeding regarding the applicability of the penalty is "conclusive" in the refund proceeding. *Ibid.*

Under Treasury regulations implementing the Taxpayer Relief Act, "[p]artner-level defenses are limited to those that are personal to the partner or are dependent upon the partner's separate return and cannot be determined at the partnership level," such as "determinations as to whether any applicable threshold underpayment of tax has been met with respect to the partner" (*e.g.*, whether the taxpayer's individual return understated the tax owed by at least $5000). 26 C.F.R. 301.6221-1(d); see 26 U.S.C. 6662(e)(2). Such defenses do not include the "the legal and factual determinations that underlie the determination of any penalty * * * other than [those that underlie] partner-level defenses." 26 C.F.R. 301.6221-1(c).

II. FACTUAL BACKGROUND AND PROCEEDINGS BELOW

A. Execution Of The COBRA Tax Shelter

In November 1999, respondent Woods and another individual, Billy Joe ("Red") McCombs, participated in an abusive tax shelter called Current Options Bring Reward Alternatives, or COBRA. Pet. App. 4a-5a & n.2. The purpose of COBRA was to generate a large paper loss that could offset real gains that the taxpayer realized in a given tax year. *Id.* at 5a. McCombs, at one time the owner of the NBA's San Antonio Spurs and the NFL's Minnesota Vikings, expected to realize significant income in 1999 from the expansion of the NFL to include the resurrected Cleveland Browns franchise. *Id.* at 16a; 9/15/2010 Trial Tr. (Afternoon Sess.) 76-77. Woods was a long-time business associate of McCombs. Pet. App. 16a.

Like a number of other tax shelters that proliferated during the late 1990s and early 2000s, COBRA was designed to enable a taxpayer to claim a large tax loss by artificially inflating his basis in a particular asset. When the asset was sold for far less than the asserted basis, the taxpayer claimed a large loss on that sale that could be used to offset real gains from other transactions. Pet. App. 5a.

To execute COBRA, a taxpayer would purchase and sell largely offsetting short-term options on a foreign currency. See generally *RA Invs. I, LLC* v. *Deutsche Bank AG*, No. 3:04-cv-1565, 2005 WL 1356446, at *1 (N.D. Tex. June 6, 2005) (describing COBRA). For example, a taxpayer might purchase a 30-day option on a foreign currency valued at $100 million while selling a 30-day option on the same currency worth $95 million—for an out-of-pocket expenditure of $5 million. The taxpayer would contribute both the "long" option and the

"short" option, plus a comparatively small amount of cash (*e.g.*, $3 million), to a partnership established with another COBRA participant solely for the purpose of the transaction. The partnership would then purchase a relatively small quantity of assets (for example, $2 million worth of publicly traded stock or a foreign currency). When the offsetting options expired, the partnership would immediately dissolve and distribute its assets to the partners. The taxpayer would then sell the distributed assets, claiming a basis in them equal to the cost of the purchased option plus the cash contributed to the dissolved partnership—in this example, $103 million, generating a $101 million artificial tax loss.

That loss was generated through a manipulation of the rules governing a partner's "outside basis" in a partnership. "Outside basis" refers to the partner's capital stake in the partnership itself, as opposed to the partnership's own basis in assets it holds, which is called "inside basis." See generally *Fidelity Int'l Currency Advisor A Fund, LLC* v. *United States*, 661 F.3d 667, 669 (1st Cir. 2011). Ordinarily, when a partner contributes property to a partnership (such as the long option), his outside basis equals his basis in the contributed property, 26 U.S.C. 705(a), 722, while the partnership's assumption of a liability from the partner (as with the short option) reduces that basis, 26 U.S.C. 733, 752(b); see *Tigers Eye*, 138 T.C. at 112-113.[5] In 1975, however, the Tax Court issued a nonprecedential memorandum opinion holding that, for purposes of the partnership

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[5] Although each partner's outside basis would simultaneously increase by his share of the partnership's assumed liability, 26 U.S.C. 752(a), it would decrease by the same amount upon the subsequent extinguishment of the liability (as when the short option terminates unexercised). 26 U.S.C. 752(b).

basis rules, the obligation to perform under a short option is too contingent to be taken into account as a "liability." See *Helmer* v. *Commissioner*, 44 T.C.M. (P-H) ¶ 75,160, at 712 (1975); cf. 26 C.F.R. 1.752-1(a)(4)(ii) (2006) (superseding *Helmer*). Taxpayers who participated in COBRA attempted to exploit that opinion to generate an artificially high basis in the assets distributed by the sham partnership upon liquidation. In the example described above, the taxpayer would claim on his tax return that his outside basis in the partnership—and therefore his basis in the assets distributed by the partnership at liquidation, see 26 U.S.C. 732(b)—was $103 million, even though he effectively contributed only $8 million to the partnership (the $5 million difference between the prices of the offsetting options, plus the $3 million in cash).

Woods and McCombs together engaged in two COBRA transactions with two sham partnerships—one to generate ordinary losses and one to generate capital losses. Pet. App. 5a-6a, 17a n.7. Limited liability companies (LLCs) owned by Woods and McCombs acquired the requisite offsetting 30-day option positions for $2.3 million and contributed those positions, plus about $900,000 in cash, to the partnerships, which used the cash to purchase Canadian dollars and Sun Microsystems stock. *Id.* at 18a. After the option positions were terminated, the LLCs contributed their interests in each partnership to separate S corporations jointly owned by Woods and McCombs, which automatically terminated the partnerships (because each was 100% owned by a single S corporation). The partnerships accordingly distributed their assets to the S corporations, which sold those assets for small economic gains. See *id.* at 5a-6a, 18a-19a; Gov't C.A. Br. 13-14. By including the cost of

the purchased options as part of the basis of those assets, Woods and McCombs claimed huge losses on the 1999 returns of the S corporations (which then flowed through to the taxpayers individually, see 26 U.S.C. 1366). Pet. App. 19a; J.A. 192-211. Taking into account fees paid to other entities to participate in COBRA, Woods and McCombs together incurred only $1.37 million in real losses on the transactions, but they claimed more than $45 million in losses on the S corporations' tax returns. See *ibid.*; 9/16/2010 Trial Tr. (Morning Sess.) 25-26; J.A. 192-211.

B. Administrative And Judicial Proceedings Below

1. In accordance with the procedure prescribed by TEFRA, the IRS issued FPAAs to the partners of each of the two partnerships. The FPAAs disallowed the tax treatment of the COBRA transactions on the ground that the transactions lacked economic substance. Under the economic-substance doctrine, a longstanding common-law principle codified by Congress in 2010, a transaction will be disregarded altogether for tax purposes—and any associated tax benefits therefore will be disallowed—if the transaction does not have economic substance. See 26 U.S.C. 7701(*o*)(5)(A).

Applying that principle, each FPAA determined that "neither [the partnership] nor its purported partners have established the existence of [the partnership] as a matter of fact." J.A. 92, 146. The FPAAs further provided that, "[e]ven if [the partnership] existed as a partnership," all of its transactions should be "disregarded in full" because "the purported partnership was formed and availed of solely for purposes of tax avoidance by artificially overstating basis in the partnership interests of its purported partners." J.A. 92, 146-147. The FPAAs thus concluded that each of the steps in the

COBRA transaction—*i.e.*, "the acquisition of any interest in the purported partnership by the purported partner," "the transfer of offsetting options to a partnership in return for a partnership interest," and "the distribution of * * * assets to [the S Corporation]"—should be treated for federal tax purposes as a practical nullity. *Ibid.* The FPAAs also provided that "any * * * claimed increases in the outside basis in [the partnership] resulting from the contributions of the foreign currency option(s) are disallowed," and that "the partners * * * have not established adjusted bases in their respective partnership interests in an amount greater than zero." J.A. 94-95, 148-149.

Consistent with the procedure required by the Taxpayer Relief Act, the FPAAs concluded that certain penalties under Section 6662 applied to any underpayment of tax resulting from the COBRA shelter. J.A. 95-97, 149-151. One of the penalties was the basis-overstatement penalty. The invalidity of the transactions for tax purposes, the IRS concluded, meant that each partner's correct outside basis in the partnerships was zero. For that reason, the FPAAs determined that a 40% penalty for a gross misstatement of basis would apply to any tax underpayment predicated on a higher outside basis figure. J.A. 96, 150; see 26 C.F.R. 1.6662-5(g).

2. Woods sued the United States in the United States District Court for the Western District of Texas under TEFRA's judicial-review provision, 26 U.S.C. 6226(a), to challenge the FPAAs.[6] He sought to contest both the IRS's conclusion that COBRA lacked economic

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[6] Although the LLCs (and then the S Corporations) were the direct partners of the two partnerships, Woods and McCombs qualify as "partners" under TEFRA. See 26 U.S.C. 6231(a)(2)(B), (9) and (10).

substance and its determination that the overstatement penalty was applicable.

The district court first upheld the IRS's determination that the COBRA transactions lacked economic substance. Pet. App. 19a-21a. The "central theory of COBRA," the court explained, "was that the basis of [the distributed partnership property] was the cost of the 'long' currency options, while the 'short' options could be disregarded for tax purposes." *Id.* at 19a. The court further explained that the "use of two partnerships with a six-week life span to conduct th[e] trading [was] for the sole purpose of generating a paper loss" via this artificially high basis in the assets distributed at liquidation. *Id.* at 20a. Based on those findings, the court concluded that the COBRA transaction "was totally lacking in economic substance," and that "both the ordinary loss and the capital loss * * * should be disregarded for tax purposes." *Id.* at 21a.

In a subsequent opinion, however, the district court held that the basis-overstatement penalty was inapplicable as a matter of law. Pet. App. 3a-14a. Citing the Fifth Circuit's decision in *Heasley* v. *Commissioner*, 902 F.2d 380 (1990), the court stated that "[i]n this Circuit * * * it is clearly established that whenever the Internal Revenue Service totally disallows a deduction, it may not penalize the taxpayer for a valuation overstatement included in that deduction." Pet. App. 6a. Because the economic-substance doctrine had the effect of precluding the deductibility of any losses claimed from the transaction, the court reasoned, the penalty was inapplicable, even though the transaction was specifically designed to generate an artificially high basis in assets. See *id.* at 6a-7a.

3. a. While the government's appeal of the district court's penalty ruling was pending, the Fifth Circuit decided *Bemont Investments, L.L.C.* v. *United States*, 679 F.3d 339 (2012), a case involving a basis-inflating tax shelter similar to COBRA. Relying on *Heasley*, *supra*, and on its prior decision in *Todd* v. *Commissioner*, 862 F.2d 540 (5th Cir. 1988), the court in *Bemont Investments* held that the basis-overstatement penalty cannot apply when the IRS treats "transactions as a sham, and disallow[s] all tax attributes flowing from the transactions in full." 679 F.3d at 347-348.

Judge Prado issued a concurring opinion that was joined by the other two members of the panel. 679 F.3d at 351. The concurring opinion explained that "[a]rguably, if the *Todd/Heasley* rule did not bind us, tax underpayment in this case would be 'attributable to' a valuation overstatement." *Id.* at 353. The "basis misstatement and the transaction's lack of economic substance," Judge Prado reasoned, "are inextricably intertwined" because "[t]he basis misstatement was the engine of, the vehicle behind the sham transaction." *Id.* at 354. He further explained that COBRA's lack of economic substance "pulls the correct basis to zero, which eliminates the claimed loss, and renders the tax underpaid." *Ibid.* As a result, "disregarding the transaction for a lack of economic substance does not alter the reality that the tax underpayment was ultimately 'attributable to' the basis misstatement—or so one could argue, in a world without *Todd/Heasley*." *Ibid.* Judge Prado observed that "the *Todd/Heasley* rule could incentivize improper tax behavior" because it rewards taxpayers who do not merely misstate their basis in property but who "craft[ ] a more extreme scheme." *Id.* at 355.

b. Citing *Bemont Investments*, as well as *Todd* and *Heasley*, a different panel of the Fifth Circuit affirmed the district court's penalty ruling in this case in a one-paragraph per curiam opinion. Pet. App. 1a-2a.

SUMMARY OF ARGUMENT

The courts below correctly exercised jurisdiction to review the FPAAs' penalty-related determinations in this case. The courts erred, however, in holding that the basis-overstatement penalty is inapplicable when a basis-inflating transaction is found to lack economic substance.

A. 1. The district court had jurisdiction to decide in this partnership-level proceeding whether the basis-overstatement penalty applies to underpayments of tax resulting from invalid claims of loss on sham transactions. Under the Taxpayer Relief Act, a district court in a partnership-level proceeding has jurisdiction to determine "the applicability of any penalty * * * which relates to an adjustment to a partnership item." 26 U.S.C. 6226(f). That language encompasses the present dispute. The overstatement penalty "relates to," because it is imposed as a direct consequence of, the IRS's "adjustment[s] to * * * partnership item[s]"—specifically, the determinations, upheld by the district court, that the partnerships were shams created to inflate the partners' bases in the distributed assets, and that the COBRA transactions therefore were nullities for tax purposes.

Recent decisions from the D.C. and Federal Circuits have suggested that, if a penalty rests on an overstatement of a partner's *outside* basis in a partnership, an affected item, it does not "relate to" an adjustment to a partnership item. See *Jade Trading, LLC* v. *United States*, 598 F.3d 1372, 1378-1380 (Fed. Cir. 2010); *Peta-*

luma FX Partners, LLC v. *Commissioner*, 591 F.3d 649, 654 (D.C. Cir. 2010). That reasoning is flawed. The fact that the penalty rests on an affected item actually *confirms* that it "relates to" an adjustment to a partnership item. An affected item, by definition, is a non-partnership item whose determination is affected by a partnership item. 26 U.S.C. 6231(a)(5). When a partnership item is adjusted in a way that requires an adjustment to an affected item and triggers a penalty, the penalty "relates to" the adjustment to the partnership item.

2. The interpretation suggested by the D.C. and Federal Circuits appears to reflect a concern that the court in a partnership-level proceeding cannot finally determine whether individual partners are subject to overstatement penalties premised on misstatements of outside basis because those determinations require further partner-level inquiries. That is true of virtually *any* penalty subject to the Taxpayer Relief Act procedure, however, since penalties are imposed on individual partners rather than on the partnership itself, and are premised on individual partners' underpayments of tax when they file their own returns. Congress nevertheless authorized both the IRS and the reviewing court to determine the "applicability" of penalties in partnership-level proceedings, while permitting partners to raise "partner level defenses" in refund proceedings. 26 U.S.C. 6230(c)(4). To hold that "the applicability of a penalty" cannot be determined in partnership-level proceedings unless no further partner-level determinations are required would effectively nullify Section 1238 of the Taxpayer Relief Act.

Read in context, the directive that courts determine the "applicability" of penalties in partnership-level pro-

ceedings means that the court should decide whether an error with respect to a partnership item, if reflected in a partner's own return, could trigger the penalty. After partnership-level proceedings conclude, the IRS determines whether to impose a penalty on any individual partner and, if so, assesses the penalty without having to follow the ordinary deficiency procedures. 26 U.S.C. 6230(a)(2). The partner may then challenge that determination in a refund proceeding. 26 U.S.C. 6230(c)(1) and (3).

That understanding of the statute's operation best effectuates the objectives of the Taxpayer Relief Act. Congress carved out an exception to the ordinary deficiency procedures for penalties related to partnership-level adjustments in order to relieve the administrative burden on the agency and the Tax Court. Congress established a reticulated scheme under which issues common to all partners, including issues concerning the applicability of penalties, would be conclusively resolved at the partnership level, while "partner level defenses" would be entertained in refund proceedings initiated by individual partners. See 26 U.S.C. 6230(c)(4). The merits question presented here—*i.e.*, whether the basis-overstatement penalty may be imposed on taxpayers who claim loss deductions premised on sham transactions—is a pure question of law whose resolution does not depend on factors specific to any individual partner. Deferring that issue to partner-level proceedings would create a risk of inconsistent decisions and would restore the inefficient scheme that Congress intended to do away with.

B. 1. Section 6662 of the Internal Revenue Code provides that the overstatement penalty shall apply to "the portion of any underpayment which is attributable to

* * * [a] substantial valuation misstatement." 26 U.S.C. 6662(b)(3). The term "substantial valuation misstatement" is defined to include certain situations in which the "adjusted basis of any property" is found to have been overstated. 26 U.S.C. 6662(e)(1)(A); see p. 4 & n.2, *supra*. Given the plain meaning of the word "attributable," the penalty applies whenever a substantial overstatement of basis causes or generates an underpayment of tax. See *Braunstein* v. *Commissioner*, 374 U.S. 65, 70 (1963). That causal link is generally (and readily) shown when a taxpayer uses an inflated basis to calculate his gain or loss from the sale of property, uses the inaccurate gain or loss figure to calculate his overall taxable income, and consequently pays less income tax than he actually owes. The "underpayment" that is "attributable to" the basis overstatement is the difference between the amount of tax actually paid and the amount of tax the taxpayer would have paid if he had used the correct basis figure and calculated his tax liability accordingly.

In one respect, the basis overstatements at issue here differ from more commonplace basis errors. The overstatements arise not from the taxpayers' factual misrepresentation about a particular purchase price or value, but rather from their erroneous asserted belief about the effect of the COBRA transactions on the bases of the distributed partnership assets on which they claimed a loss. The causal link between the basis overstatements and the underpayments of tax, however, was precisely the same as in the more typical situation.

Woods and McCombs ultimately paid far less tax than they owed, and far less tax than they would have paid if they had calculated their tax liabilities using as their bases in the purported partnerships the amount

(zero) that was ultimately determined to be correct. Their underpayments of tax therefore were "attributable to" their overstatements of basis in the same sense that tax underpayments are "attributable to" basis overstatements arising from more prosaic errors. Nothing in Section 6662 exempts a basis overstatement caused by an erroneous understanding of how to account for transactions in computing basis. And in numerous other contexts where Congress surely intended the penalty to be imposed, a basis overstatement can arise from a misapplication of basis-computation rules rather than from a factual inaccuracy.

2. The court of appeals' contrary view rests principally on the court's misinterpretation of a passage from the *Blue Book*. The relevant passage describes a situation in which two *different* deductions are improper, one because of a basis overstatement and one for a separate reason. The *Blue Book* sets forth a useful formula for isolating the portion of the total underpayment of tax that is "attributable to" the basis overstatement. In *Todd* v. *Commissioner*, 862 F.2d 540 (5th Cir. 1988), however, the court of appeals misinterpreted that passage to foreclose the overstatement penalty where the *same* deduction that reflects a basis overstatement is invalid on an alternative ground as well. See *id.* at 542-543. The *Blue Book* formula was not intended for that circumstance, and the court's holding has no support in the statute's text.

In any event, even if the rule announced in *Todd* was correct in an "alternative grounds" scenario, it would not bar imposition of the overstatement penalty here. The determination that COBRA lacked economic substance was not a ground for disallowance that was independent of the basis overstatement. Rather, the deter-

mination that each partner's actual basis in the partnership assets was zero, and that the partners' use of much larger bases constituted gross valuation misstatements, followed directly and necessarily from the determination that the COBRA transactions lacked economic substance. No plausible reading of Section 6662 or the *Blue Book* supports the court of appeals' holding that the penalty cannot apply in that circumstance.

3. The court of appeals' interpretation of the overstatement penalty would frustrate the penalty's purpose of deterring large basis overstatements. It would render the penalty inapplicable to particularly serious abuses where a taxpayer has engaged in a series of sham transactions designed to create the illusion that he has a far higher basis in an asset than he does. And it would foster the inequity that taxpayers who make simple errors on their returns are subject to a penalty that does not apply to those who engage in far more egregious misconduct.

ARGUMENT

A. The Courts Below Had Jurisdiction To Determine, In This Partnership-Level Proceeding, Whether A Claimed Loss Deduction Premised On A Sham Transaction Can Give Rise To A Basis-Overstatement Penalty

In its order granting certiorari in this case, the Court directed the parties to brief the following question: "Whether the district court had jurisdiction in this case under 26 U.S.C. § 6226 to consider the substantial valuation misstatement penalty." In the government's view, the district court did have jurisdiction.

Under the Taxpayer Relief Act, when an appropriate partner seeks judicial review of an FPAA, the district court in considering the petition for review has jurisdiction to determine, *inter alia*, "the applicability of any

penalty * * * which relates to an adjustment to a partnership item." 26 U.S.C. 6226(f); see 26 U.S.C. 6221. Section 6226(f) authorized the courts below to determine whether errors at the partnership level, if carried over to the individual partners' returns, could give rise to penalties under Section 6662. The basis-overstatement penalty "relates to" the "adjustment[s] to * * * partnership item[s]"—specifically, the determinations that the partnerships and transactions involving the partnerships were shams that must be disregarded for tax purposes. In light of those determinations, which (once reviewed and upheld by the reviewing courts) would be binding in any subsequent partner-level proceeding, the individual partners are potentially subject to overstatement penalties for using amounts greater than zero as the basis of assets distributed by the partnerships. That link establishes that the basis-overstatement penalty "relates to" the relevant "adjustment[s]."

To be sure, any basis-overstatement penalties that are ultimately imposed will be imposed on the individual partners rather than on the partnerships themselves. The partners' liability for those penalties depends, moreover, on whether the partners used the inflated basis figures for the partnership assets in calculating their own tax obligations. Recent rulings by the D.C. and Federal Circuits have suggested (without definitively holding) that those aspects of the statutory scheme preclude the court in a Section 6226 review proceeding from considering penalty-related issues in circumstances like the present one. See *Jade Trading, LLC* v. *United States*, 598 F.3d 1372, 1378-1380 (Fed. Cir. 2010); *Petaluma FX Partners, LLC* v. *Commissioner*, 591 F.3d 649, 653 (D.C. Cir. 2010).

Read in isolation, Section 6226(f)'s authorization to determine the "applicability" of certain penalties could plausibly be read as limited to circumstances where the court has before it all the information it needs to decide definitively whether a particular person must pay a particular penalty. That language tracks the text of Section 6221, which governs the IRS's administrative review and similarly provides that "the applicability of any penalty * * * which relates to an adjustment to a partnership item[] shall be determined at the partnership level." 26 U.S.C. 6221. Given the larger statutory context in which it appears, however, the statutory command that the IRS and the reviewing court determine "the applicability of any penalty" at the partnership level would be a practical nullity if it were limited to situations where no further partner-level inquiries were needed. "When Congress enacted the penalty litigation amendments, it was well aware that a partnership-level proceeding under TEFRA does not result in the determination of an underpayment at the partnership level." *Tigers Eye Trading, LLC* v. *Commissioner*, 138 T.C. 67, 140 (2012). In directing the IRS and reviewing courts to make partnership-level determinations concerning the "applicability" of penalties, Congress must have had in mind an inquiry less comprehensive and particularized than the one needed to determine whether penalties should actually be imposed on specific partners.

Under an appropriate contextual interpretation, the IRS or a reviewing court determines the "applicability" of a penalty by deciding whether a particular error with respect to a partnership item, if reflected in the returns of individual partners, could trigger the penalty. That reading reflects a commonplace use of the word "applicability," and it is the only understanding of the stat-

ute that effectuates Congress's purpose to reduce the workload of the IRS and the Tax Court by exempting penalties related to adjustments to partnership items from the Internal Revenue Code's ordinary deficiency procedures. Congress intended the IRS to assess such penalties instead through computational adjustments, subject to judicial review through taxpayer-initiated refund proceedings. That streamlined process conserves administrative and judicial resources and avoids inconsistent determinations on issues whose resolution does not logically depend on factors specific to individual partners.

1. The basis-overstatement penalty applicable here "relates to" adjustments to partnership items

a. Under the Taxpayer Relief Act, "the applicability of any penalty * * * which relates to an adjustment to a partnership item [must] be determined at the partnership level" through the IRS's issuance of an FPAA. 26 U.S.C. 6221. If a timely petition for review of the FPAA is filed, the reviewing court in turn has "jurisdiction to determine * * * the applicability of any penalty * * * which relates to an adjustment to a partnership item." 26 U.S.C. 6226(f). Accordingly, a court has jurisdiction in a partnership-level proceeding to determine whether a particular tax penalty is applicable whenever (i) the court has made or upheld an "adjustment to a partnership item," and (ii) the penalty "relates to" that adjustment. Both of those requirements are met here.

The IRS determined, and the district court agreed, that the COBRA transactions lacked economic substance and therefore must be disregarded for tax purposes. That determination constituted an "adjustment to a partnership item." 26 U.S.C. 6221, 6226(f). TEFRA defines a "partnership item" as "any item required to be

taken into account for the partnership's taxable year under any [income tax] provision" that, as provided in the pertinent Treasury regulations, "is more appropriately determined at the partnership level than at the partner level." 26 U.S.C. 6231(a)(3). A regulation defines a "partnership item" to include "[t]he partnership aggregate and each partner's share of * * * [i]tems of income, gain, loss, deduction, or credit of the partnership," as well as "[c]ontributions to the partnership" by the partners, including "the partner's basis in the contributed property," and certain "[d]istributions from the partnerships." 26 C.F.R. 301.6231(a)(3)-1(a)(1)(i), (4)(i), (ii) and (c)(2)(iv). In addition, "the legal and factual determinations that underlie the determination of the amount, timing, and characterization" of those items are themselves partnership items. 26 C.F.R. 301.6231(a)(3)-1(b). As an implementation of an express delegation of authority to the agency, that regulation is entitled to *Chevron* deference. See *United States* v. *Mead Corp.*, 533 U.S. 218, 229 (2001).

As several circuits have held, a "determination that a partnership is a sham and lacks economic substance is a partnership item because it is a legal determination that underlies the amount and characterization of other partnership items." *Petaluma*, 591 F.3d at 653; see *Napoliello* v. *Commissioner*, 655 F.3d 1060, 1065 (9th Cir. 2011); *RJT Invs. X* v. *Commissioner*, 491 F.3d 732, 738 (8th Cir. 2007); see also *Duffie* v. *United States*, 600 F.3d 362, 378-379 (5th Cir.), cert. denied, 131 S. Ct. 355 (2010); *Keener* v. *Commissioner*, 551 F.3d 1358, 1366 (Fed. Cir.) (partnership transactions), cert. denied, 558 U.S. 825 (2009). In other words, the determination that a partnership may not be recognized for federal tax purposes means that none of the other partnership

items, such as income, losses, contributions, and distributions, may be recognized. See *Petaluma*, 591 F.3d at 653 ("The determination that a valid partnership exists is a *sine qua non* for determining the amount and characterization of all other partnership items."). And "[l]ogically, it makes perfect sense to determine whether a partnership is a sham at the partnership level" because "[a] partnership cannot be a sham with respect to one partner, but valid with respect to another." *Id.* at 654.

Accordingly, the district court's holding that COBRA lacked economic substance was an adjustment to a partnership item. That overarching adjustment had the effect of negating each of the transactions that made up the COBRA shelter. It therefore also resulted in the elimination of (*i.e.*, adjustments to) other partnership items, such as contributions to and distributions from the partnerships. See 26 C.F.R. 301.6231(a)(3)-1(a)(4)(i), (ii) and (b).

The second requirement for jurisdiction under Section 6226(f) is also met: Any overstatement penalty assessed in this case would "relate[] to" the "adjustment[s] to the partnership item[s]" made by the district court—*i.e.*, the legal determination that the partnerships were shams and that their transactions must be disregarded. The ordinary meaning of the word "relate" is "to bring into or establish association, connection, or relation." *Random House Unabridged Dictionary* 1626 (2d ed. 1993); see *Commissioner* v. *Brown*, 380 U.S. 563, 570-571 (1965) (where common term "is used in the Code without limiting definition," its ordinary meaning should be given effect). Accordingly, a penalty "relates to" an adjustment to a partnership item "if it has a connection with or reference to" the adjustment, at least where the

connection is not too "tenuous" or "remote." *Morales* v. *Trans World Airlines, Inc.*, 504 U.S. 374, 384, 390 (1992) (citation omitted).

An evident connection exists between the district court's sham determination and any overstatement penalty that could be assessed here. The determination that the partnership and its transactions must be disregarded for tax purposes means that any claimed basis greater than zero in the distributed assets was an overstatement. Any overstatement penalty assessed in this case will be assessed because the partners claimed a basis higher than zero in those assets. The court's partnership-item adjustments therefore "relate[] to" the overstatement penalty.

b. The D.C. and Federal Circuits have suggested, in cases with similar facts, that the overstatement penalty does not "relate to" the determination that a partnership is a sham and that its transactions must be disregarded. See *Petaluma*, 591 F.3d at 655-656; *Jade Trading*, 598 F.3d at 1378-1380. Those courts have emphasized that in shelters like COBRA, the basis overstated is the partners' outside basis in the partnership, which attaches to the assets distributed by the partnership on liquidation, see 26 U.S.C. 732(b). Outside basis is ordinarily an affected item rather than a partnership item: it is generally not an item that the partnership is required to take into account, but it is affected by partnership items like capital contributions and distributions. See 26 C.F.R. 301.6231(a)(5)-1(b).[7] The D.C. and Feder-

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[7] Outside basis could be a partnership item in circumstances not relevant here in which it is a component of another partnership item, such as inside basis. See, *e.g.*, *Home Concrete & Supply, LLC* v. *United States*, 634 F.3d 249, 252 (4th Cir. 2011), aff'd, 132 S. Ct. 1836 (2012).

al Circuits have thus reasoned that "the [overstatement] penalty * * * relates to an adjustment of an affected item, not a partnership item" as required by Section 6226(f). *Jade Trading*, 598 F.3d at 1380; see *Petaluma*, 591 F.3d at 655 ("True, the determination that [the partnership] should be disregarded for tax purposes is a partnership item, but the outside bases of the partners are affected items to be resolved at the partner level.").

That analysis ignores the relationship between partnership items and affected items. It is true that any overstatement penalty ultimately imposed on the taxpayers in this case will be premised on misstatements of outside basis, an affected item. Far from demonstrating that the penalty does not "relate[] to" an adjustment to a partnership item, however, the link between the penalty and an affected item confirms that the requisite "relat[ionship]" exists. An "affected item" is "any item to the extent such item is affected by a partnership item." 26 U.S.C. 6231(a)(5). Thus, an adjustment to a partnership item will typically require an associated adjustment to the affected item. When a penalty is triggered by an inaccurate affected item, and the affected item is rendered inaccurate because of an adjustment to a partnership item, the penalty logically "relates to" the adjustment to the partnership item.

Here, for example, the district court's determinations that the partnerships were shams, and that the contributions to the partnerships therefore should be given no tax effect—both adjustments to partnership items—precluded the partners from claiming outside bases greater than zero, implicating the overstatement penalty. The concomitant nullification of the distributions of the assets to the partners—another adjustment to a partnership item—likewise precluded the partners from

claiming a basis in those assets equal to their (purported) outside bases in the partnerships. There is consequently a direct causal relationship between the adjustments to partnership items and the applicability of the penalty. The penalty "relates to" the adjustments because the penalty would not be applicable without the adjustments.

That interpretation does not render the "relates to" limitation superfluous. All penalties that are related only to non-partnership items that are not affected items—*i.e.*, penalties that may apply to any individual partner for reasons unconnected to any error at the partnership level—are excluded from the Taxpayer Relief Act procedure. For example, a penalty might be imposed for a partner's failure to report income from a non-partnership source. The same is true of penalties for misstating affected items if liability for such penalties does not turn on adjustments to partnership items.

2. The IRS and the courts can determine the "applicability" of particular penalties in partnership-level proceedings, even though the ultimate decision whether to impose a penalty will depend in part on partner-level inquiries

a. As the D.C. and Federal Circuits have emphasized, the ultimate imposition of overstatement penalties in cases like this one will require some partner-level inquiries after the partnership-level proceedings have been completed. See *Petaluma*, 591 F.3d at 655-656; *Jade Trading*, 598 F.3d at 1378-1380. Read in isolation, Section 6226(f)'s authorization to determine the "applicability" of certain penalties could plausibly be read as limited to circumstances where the court has before it all the information it needs to decide whether a particular person is subject to a particular penalty. The lan-

guage of Section 6226(f) does not compel that reading, however, and the larger statutory context makes clear that it is incorrect.

For virtually *any* penalty subject to the Taxpayer Relief Act procedure, including all of the accuracy-related penalties set forth in Section 6662, some further partner-level inquiry will be necessary even after the partnership-level proceedings are complete. A partner's actual liability for any Section 6662 accuracy-related penalty requires that she have actually underpaid income tax, see 26 U.S.C. 6662(a), which would not be true if (for example) her taxable income were eliminated by other, legitimate losses. Because such facts cannot be known solely from examining the partnership's return and records, the Taxpayer Relief Act expressly provides that "partner level defenses" may be raised in a refund proceeding after the conclusion of the partnership-level proceedings. 26 U.S.C. 6230(c)(4); see, *e.g.*, 26 U.S.C. 6664(c) ("reasonable cause" defense to penalty liability). Section 6230(c)(4) also provides, however, that determinations in the partnership-level proceedings, including determinations concerning "the applicability of any penalty," are "conclusive" and unreviewable in any refund proceeding. 26 U.S.C. 6230(c)(4).

Section 6226(f)'s requirement that the reviewing court determine "the applicability of any penalty" at the partnership level therefore would be a practical nullity if it were limited to situations where liability for penalties could be finally determined in the partnership-level proceedings themselves. Section 6230(c)(4) likewise clearly presupposes that the "applicability of [a] penalty" may be determined in partnership-level proceedings even though "partner level defenses" remain to be determined. Under an appropriate contextual interpreta-

tion of the relevant phrase, the IRS or a reviewing court determines the "applicability" of a penalty by deciding whether a particular error with respect to a partnership item, if reflected in the returns of individual partners, could trigger the penalty.[8]

That reading is fully consistent with accepted understandings of the word "applicability" and its cognates. Title VII of the Civil Rights Act of 1964, for example, defines the term "employer" by reference to a 15-employee threshold. See *Arbaugh* v. *Y & H Corp.*, 546 U.S. 500, 503-504 (2006). If the parties to a particular Title VII suit disputed whether the defendant had the requisite 15 or more employees, the court in resolving that dispute would naturally be said to determine the "applicability" of Title VII, even though additional proceedings would be needed to determine whether Title VII had been *violated*. In that context, the statement that Title VII is "applicable" would simply mean that the defendant could be held liable under Title VII if it was ultimately found to have engaged in one of the discriminatory acts that the statute prohibits. Similarly in the Taxpayer Relief Act context, the court in a partnership-level proceeding can "determine * * * the applicability of [a] penalty * * * which relates to an ad-

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[8] TEFRA requires that each partner, on his own tax return, must "treat a partnership item in a manner which is consistent with the treatment of such partnership item on the partnership return," 26 U.S.C. 6222(a), or else notify the IRS of any inconsistency between the two returns, 26 U.S.C. 6222(b)(1). Section 6222 reflects Congress's judgment that, although an individual partner may sometimes have legitimate reasons for filing a return that treats partnership items differently than the items are treated on the partnership return, the default assumption is that the two returns will be consistent. Section 6226(f)'s reference to the "applicability" of penalties should be construed by reference to the same assumption.

justment to a partnership item," 26 U.S.C. 6226(f), by deciding whether individual partners will be subject to the penalty if they carry forward to their own returns the erroneous partnership-level information that is the subject of the adjustment, and an underpayment of tax results.

The present case furnishes an apt illustration. The district court held, and respondent does not currently dispute, that the COBRA transaction "was totally lacking in economic substance," and that "both the ordinary loss and the capital loss * * * should be disregarded for tax purposes." Pet. App. 21a. In this Court as in the court of appeals, the disputed question on the merits is whether a taxpayer who claims a loss deduction, based on the sale of assets distributed from a partnership that is ultimately determined to be a sham, is subject to the basis-overstatement penalty if the invalid deduction results in an underpayment of tax. That question is very naturally characterized as one concerning the "applicability" of a penalty. And because the answer to that pure question of law does not depend on factors specific to any individual partner, its resolution in a partnership-level proceeding promotes the efficiency goals that TEFRA and the Taxpayer Relief Act were intended to achieve.

b. The interpretation advanced here best effectuates Congress's objectives in the Taxpayer Relief Act, and neither the D.C. Circuit nor the Federal Circuit has identified any significant policy justification for the contrary view. Congress was concerned that "applying penalties at the partner level through the deficiency procedures following the conclusion of the unified proceeding at the partnership level increases the administrative burden on the IRS and can significantly increase

the Tax Court's inventory." 1997 House Report 594. The statute therefore allows the IRS to avoid the burdensome deficiency procedures when it assesses a penalty related to a partnership-level error that has been identified in an FPAA or by a court. Instead, the IRS may simply assess the penalty, where appropriate, after reviewing the partners' individual returns. The Taxpayer Relief Act then places the onus on each partner to challenge the assessment of the penalty in a refund proceeding if he believes that any individualized considerations negate his liability. See *ibid.*

That streamlined procedure not only reduces the burden on the agency and the Tax Court, but also avoids inconsistent treatment of different partners with respect to the same penalty. For example, if it is determined in a partnership-level proceeding that the negligence penalty applies because the partnership "fail[ed] to make a reasonable attempt to comply with" the tax laws, 26 U.S.C. 6662(b)(1) and (c), that determination will be binding in any subsequent refund proceeding. But if the Taxpayer Relief Act procedure were deemed inapplicable to any penalty that requires further partner-level determinations—*i.e.*, virtually all penalties—the IRS would be forced to litigate the common question of partnership negligence piecemeal against individual partners in the Tax Court, potentially leading to inconsistent rulings. That is precisely the risk the Taxpayer Relief Act procedure was intended to eliminate.

B. Section 6662's Basis-Overstatement Penalty Applies To An Underpayment Of Tax That Results From Claiming A Basis Derived From Transactions That Lacked Economic Substance

The plain text of Section 6662 refutes the court of appeals' conclusion that penalties for basis overstatements

cannot be imposed when a basis-inflating transaction is disregarded as lacking economic substance. In such a case, any underpayment of tax is "attributable to" an overstatement of basis because the taxpayer would have paid additional tax if she had used the correct basis on her return. The court of appeals' mistaken view, which has been rejected by eight other circuits (see Pet. 21-29), rested principally on a misreading of a passage from the *Blue Book*. Under the court's interpretation, moreover, taxpayers who engage in elaborate sham transactions for the sole purpose of inflating their bases in assets—often by tens of millions of dollars—would be immune from a penalty that applies to many other taxpayers who commit far less serious errors.

1. The plain text of Section 6662 makes the basis-overstatement penalty applicable when an underpayment of tax results from claiming a basis derived from transactions that lacked economic substance

a. Section 6662 of the Internal Revenue Code provides that a penalty shall be imposed on "the portion of any underpayment which is attributable to * * * [a] substantial valuation misstatement." 26 U.S.C. 6662(b)(3); see 26 U.S.C. 6662(h)(1) (applying greater penalty to the "portion of the underpayment * * * attributable to one or more gross valuation misstatements"). The term "substantial valuation misstatement" is defined to include overstatements of the "adjusted basis of any property." 26 U.S.C. 6662(e)(1)(A); see p. 4 & n.2, *supra*. The word "attributable" means "capable of being attributed," and to "attribute" is to "explain as caused or brought about by." *Webster's Third New International Dictionary of the English Language* 141, 142 (1993). As this Court explained in construing the words "gain attributable to such property" in another

provision of the Internal Revenue Code, "the phrase 'attributable to' merely confines consideration to that gain caused or generated by the property in question." *Braunstein* v. *Commissioner*, 374 U.S. 65, 70 (1963). An underpayment of tax therefore is "attributable to" an overstatement of basis if the overstatement "caused or generated" the underpayment.

For purposes of computing a taxpayer's gain or loss from the sale of property, the gain or loss is the difference (which may be positive or negative) between the amount realized from the sale and the taxpayer's adjusted basis in the property. See 26 U.S.C. 1001(a). If a taxpayer overstates the adjusted basis of a sold asset while accurately reporting the sale proceeds, the natural (indeed, mathematically inevitable) effect of the basis overstatement is to reduce the gain or increase the loss associated with the sale. If that inaccurate gain or loss is used to calculate the taxpayer's overall taxable income, an understatement of taxable income and a concomitant underpayment of tax may result. In prescribing penalties for tax underpayments "attributable to * * * substantial valuation misstatement[s]," and in defining the term "substantial valuation misstatement" to include overstatements of adjusted basis, Congress presumably intended that this causal link would trigger the imposition of penalties.

The COBRA tax-avoidance mechanism has the requisite causal connection to the ultimate underpayment of tax. As the district court explained, "the whole point of the COBRA strategy" is to create a huge paper loss by claiming that "the basis of [the distributed partnership property] [is] the cost of the 'long' currency options" contributed by the taxpayers, "while the 'short' options [can] be disregarded for tax purposes." Pet. App. 19a.

For federal tax purposes, however, there can be no partnership interests in a partnership that has been disregarded as a sham and, consequently, no basis in such nonexistent interests. See *Petaluma* v. *Commissioner*, 131 T.C. 84, 100 (2008), aff'd in part and rev'd in part, 591 F.3d 649 (D.C. Cir. 2010). Once the COBRA transactions in this case were determined to be a sham that had no purpose other than tax avoidance, the partners were not permitted to derive their outside bases in the partnerships from those transactions, and were required instead to use a basis figure of zero to compute their gain or loss from the sale of the distributed assets. See J.A. 95, 149. If the partners use a basis greater than zero, any resulting underpayment of tax is "attributable to" a basis overstatement. The use of the incorrect outside basis figure is what generates the underpayment.

b. In one respect, the basis overstatement produced by a shelter like COBRA differs from the run-of-the-mill case in which a taxpayer simply overstates the value or purchase price of an asset. The overstatement in the COBRA context arises not from the taxpayer's factual misrepresentation about the value of a particular asset, but rather from her erroneous asserted belief about the legal status of the COBRA transactions and their impact on her basis in the distributed assets.

That difference, however, is immaterial to the application of the overstatement penalty. The statutory definition of "substantial valuation misstatement," 26 U.S.C. 6662(e)(1)(A), does not distinguish between basis overstatements that result from factual errors and those caused by legal errors regarding the basis-calculation rules. This distinction is similarly irrelevant to the question whether the individual partners' underpay-

ments of tax were "attributable to" the basis overstatement. By treating as their S corporations' bases in the partnerships amounts that were (substantially) greater than the correct amount of zero, Woods and McCombs claimed large paper losses to which they were not entitled, which in turn caused them to underreport their overall taxable income and ultimately to underpay their taxes. That is precisely the same causal link that exists between taxpayers' overstatements of basis and their resulting underpayments of tax in cases involving inflation of the value or purchase price of an asset.

Indeed, in many contexts other than transactions that lack economic substance, a basis overstatement is produced by a misapplication of basis-computation rules rather than by a simple factual error. For example, a corporation may overstate its basis in a subsidiary due to a misapplication of regulations relating to consolidated returns. See 26 C.F.R. 1.1502-32. If the corporation were to determine its gain or loss on the sale of the subsidiary using the overstated basis, resulting in an understatement of the corporation's overall taxable income and ultimately in an underpayment of tax, the overstatement penalty would surely apply. There is no sound reason for a different result here, where the partners claimed a large basis that was erroneous in light of the underlying transactions' lack of economic substance.

Nor does the fact that the legally correct basis in the assets distributed in a COBRA shelter is zero bar application of the overstatement penalty. The statute contains "no suggestion that the penalty should not apply when the correct basis * * * is determined to be zero because the transaction is completely lacking in economic substance." *Gustashaw* v. *Commissioner*, 696 F.3d 1124, 1136 (11th Cir. 2012). Regardless of whether an

underpayment of tax results from an overstatement of basis in property having a correct basis of zero or in property having a correct basis greater than zero, the underpayment is "attributable to" an overstatement of basis.

Even if Section 6662 were ambiguous on that question, the issue was resolved in 1991 by Treasury Regulation 1.6662-5(g), which provides that the "adjusted basis claimed on a return of any property with a correct * * * adjusted basis of zero is considered to be 400 percent or more of the correct amount." 26 C.F.R. 1.6662-5(g). In that circumstance, the regulation instructs, "[t]here is a gross valuation misstatement with respect to such property." *Ibid.* That regulation reflects a reasonable interpretation of Section 6662 and is accordingly entitled to judicial deference. See *Chevron U.S.A. Inc.* v. *NRDC*, 467 U.S. 837, 842-845 (1984); see also *Mayo Found. for Med. Educ. & Research* v. *United States*, 131 S. Ct. 704, 711-714 (2011) ("We see no reason why our review of tax regulations should not be guided by agency expertise pursuant to *Chevron* to the same extent as our review of other regulations.").

2. The* Blue Book *does not support the interpretation of the basis-overstatement penalty adopted by the court of appeals

The court of appeals' understanding of the overstatement penalty rested on a mistaken interpretation of a passage in the *Blue Book*. The Fifth Circuit adopted that reading in its 1988 decision in *Todd* v. *Commissioner*, 862 F.2d 540, in which it erroneously held that when the *same* deduction is improper for two alternative reasons, only one of which is a basis overstatement, the penalty does not apply. That reading conflicts with the plain text of Section 6662, and it reflects a misinterpre-

tation of the relevant passage from the *Blue Book*, which discussed a hypothetical scenario involving two *different* deductions. But even if *Todd* were correctly decided, it would not support the Fifth Circuit's decision in the present case, where the determination that the partnerships lacked economic substance was inextricably linked to the conclusion that the partners had overstated their bases in their partnership interests.

a. In *Todd*, the court of appeals considered whether the basis-overstatement penalty could be imposed on taxpayers who had claimed large deductions and tax credits as part of a scheme involving the purchase of refrigerated containers for agricultural products. See 862 F.2d at 540-541. The IRS had concluded that for many participating taxpayers, including the plaintiffs, the deductions and credits were improper in their entirety because the containers had not been placed in service in the years for which the deductions and credits had been claimed. See *id.* at 541. The IRS had also determined, however, that all participating taxpayers had vastly overstated their bases in the property by counting as part of the purchase price of each container not only the cash paid, but also the principal amount of an illusory promissory note. See *ibid.*

The Fifth Circuit held that the basis-overstatement penalty could not be imposed on the plaintiffs because, in the court's view, the underpayment of tax was "attributable to" the disallowance of the deduction for failure to place the units in service during the relevant tax years, rather than to the overstatement of basis in the refrigerated units. See 862 F.2d at 541-545. The court deemed the words "attributable to" ambiguous as applied to a deduction that, in addition to being invalid in part because it was premised on an overstatement of

basis, was invalid in its entirety for a reason independent of that overstatement. Finding the "formal legislative history" of the Economic Recovery Tax Act unhelpful on the question, the court turned to the formula set forth in the *Blue Book*: that the "underpayment resulting from a valuation overstatement" equals "actual tax liability (i.e., the tax liability that results from a proper valuation and which takes into account any other proper adjustments)" minus "actual tax liability as reduced by taking into account the valuation overstatement." *Blue Book* 333; see *Todd*, 862 F.3d at 542-543. The court of appeals reasoned that, in the case before it, the taxpayers' "actual tax liability" was no greater than their "actual tax liability as reduced by taking into account the valuation overstatement." *Id.* at 543 (citation omitted). The court explained that, "where the deductions and credits for these refrigeration units were inappropriate altogether, the [taxpayers'] valuation of the property supposedly generating the tax benefits had no impact whatsoever on the amount of tax actually owed." *Ibid.*

That holding reflected a misreading of the *Blue Book*. See *Bemont Invs., L.L.C.* v. *United States*, 679 F.3d 339, 352 (5th Cir. 2012) (Prado, J., concurring); Pet. 21-29 (citing cases). The pertinent *Blue Book* passage, reprinted above, describes a situation in which a taxpayer understates his taxable income by $40,000 by claiming two *different* improper $20,000 deductions, one of which is excessive because it is based on a valuation overstatement, and the other of which "is disallowed totally for reasons apart from the valuation overstatement." *Blue Book* 333 n.2; see pp. 6-7, *supra*. The *Blue Book* simply explains that only the deduction to which the basis overstatement pertains, and not the unrelated deduction, should be considered in determining what

portion of the underpayment of tax is "attributable to" the basis overstatement. See *ibid.*

Todd, by contrast, involved a *single* deduction that was both overstated due to a basis misstatement and disallowed in its entirety due to an unrelated legal defect. The *Blue Book* does not address the proper application of Section 6662 to that scenario. The *Blue Book* does not, in particular, endorse the anomalous result that follows from the *Todd* court's analysis, under which the existence of an *additional* ground for disallowing a deduction may serve to exempt a taxpayer from a penalty to which he would otherwise be subject. Indeed, some of the taxpayers who had participated in the same scheme at issue in *Todd* but who had placed the units in service in the correct tax year were subject to the basis-overstatement penalty, underscoring the inequity of the court of appeals' holding. See 862 F.2d at 541.

In any event, the *Blue Book*, a post-enactment legislative report, could not trump the plain text of Section 6662. By overstating their basis in the property, the plaintiffs in *Todd* claimed a larger deduction—and thus paid less tax—than they would have paid if their basis in the refrigerated units had been accurately reported. To be sure, even accurate reporting of the plaintiffs' basis in the units would have resulted in *some* underpayment of tax, given the IRS's determination that no deduction was permissible because the units had not been placed in service. But the difference between that smaller underpayment and the larger underpayment that actually occurred is naturally characterized as "attributable to" the basis overstatement. See *Todd* v. *Commissioner*, 89 T.C. 912, 914 (1987) (noting that the government sought the overstatement penalty "only with respect to the difference between the basis claimed on the return

* * * and [the plaintiffs'] cash investment"), aff'd, 862 F.2d 540 (5th Cir. 1988).

b. The deductions at issue in *Todd* were disallowed in their entirety on a ground *unrelated* to the taxpayers' overstatements of basis. In subsequent decisions, however, including in this case, the Fifth Circuit has extended the *Todd* rule to encompass *all* cases involving total disallowance of deductions. In *Heasley* v. *Commissioner*, 902 F.2d 380 (5th Cir. 1990), the court stated that "[w]henever the I.R.S. totally disallows a deduction or credit, the I.R.S. may not penalize the taxpayer for a valuation overstatement included in that deduction or credit." *Id.* at 383; see *Bemont Invs.*, 679 F.3d at 347-348. In such a case, the Fifth Circuit has concluded, "the underpayment is not attributable to a valuation overstatement," but rather "is attributable to claiming an improper deduction or credit." *Heasley*, 902 F.3d at 983. The court has applied that approach "even if the possible grounds for denying the same deduction—overvaluation and a lack of economic substance, for example—emerge from the same factual nucleus." *Bemont Invs.*, 679 F.3d at 353 (Prado, J., concurring).

Even if *Todd* established the correct rule for cases in which a deduction premised on an overstatement of basis is also subject to disallowance on an unrelated ground, there would be no plausible rationale for extending the rule to a case like this one. Here, the IRS's determination that each partner had a zero basis in the distributed partnership assets was inextricably linked to its determination that the relevant partnerships lacked economic substance. The economic-substance finding was not an independent ground for disallowing the partners' claimed deductions; it was the reason why the

basis figures on which those deductions were premised were legally incorrect.

Taken literally, the Fifth Circuit's language in *Heasley* suggests that the basis-overstatement penalty would be inapplicable if the IRS concluded that the true adjusted basis in sold property was less than or equal to the property's sale price, and accordingly disallowed the taxpayer's claimed loss deduction in its entirety. That cannot be right. When the IRS's *reason* for wholly disallowing a claimed deduction is that the deduction rests on an overstatement of basis, the disallowance cannot plausibly be thought to break the causal chain between the overstatement and the ultimate underpayment of tax. The underpayment is accordingly "attributable to" the overstatement of basis, and the Section 6662 penalty applies. That is the case here.[9]

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[9] In 1992, the IRS issued non-binding guidelines for its attorneys, in which the agency outlined its litigation position on the overstatement penalty and stated its disagreement with *Heasley*. See Litigation Guideline Memorandum, IRS LGM TL-68, 1992 WL 1355877 (Aug. 12, 1992). With respect to *Todd*, the memorandum recommended that attorneys not seek the penalty when the taxpayer has conceded an alternative ground for disallowance prior to trial, relying on Tax Court decisions that have distinguished between pre- and post-trial concessions. In 2011, however, the IRS's Office of Chief Counsel issued a notice that instructed its attorneys to address pre-trial *Todd* concessions "on a case-by-case basis" and stated that "[p]roposed concessions should be opposed in cases involving abusive tax shelter transactions if the application of valuation misstatement penalties is at issue." Notice CC-2012-001, at 4 (Oct. 5, 2011), http://www.irs.gov/pub/irs-ccdm/cc-012-001.pdf.

3. *Under the court of appeals' interpretation of Section 6662, the most egregious misstatements of basis would be immune from the basis-overstatement penalty*

The court of appeals' interpretation of Section 6662 frustrates Congress's effort to deter overstatements of basis by penalizing taxpayers who engage in that practice. See *Fidelity Int'l Currency Advisor A Fund, LLC* v. *United States*, 661 F.3d 667, 673-674 (1st Cir. 2011). That important deterrence objective is at least as strongly implicated in the present case, where the taxpayers devised sham partnerships in order to create inflated bases in the partnership assets they intended to sell, as in the more prosaic situation where a taxpayer overstates his basis in sold property by misrepresenting the relevant facts. The IRS and the district court found in this case that Woods and McCombs had engaged in an elaborate tax shelter for the sole purpose of inflating their S corporations' bases in the distributed assets, thereby allowing the taxpayers to claim an enormous illusory tax loss and to avoid millions of dollars in income tax. The text of Section 6662 does not suggest, and there is no plausible reason to suppose, that Congress intended to exempt schemes like this one from the basis-overstatement penalty.

The Fifth Circuit's approach also creates unfair and unjustified distinctions between taxpayers. It exempts from the basis-overstatement penalty those who conduct sham transactions to give the illusion of millions of dollars in tax losses, even though taxpayers who make simple errors in computing their bases in property are subject to the penalty. As explained above (see pp. 45-46, *supra*), moreover, the rule announced in *Todd* gives *more favorable* treatment to taxpayers who claim deduc-

tions that are improper in two distinct respects—*i.e.*, deductions that reflect overstatements of basis and are disallowed on an independent ground as well—than to taxpayers who overstate their bases in sold property in claiming deductions that are otherwise appropriate. The Fifth Circuit's approach thus creates the "anomalous result [of] allowing a party to avoid tax penalties by engaging in behavior one might suppose would implicate more tax penalties, not fewer." *Keller* v. *Commissioner*, 556 F.3d 1056, 1061 (9th Cir. 2009). Nothing in the text, history, or purposes of Section 6662 suggests that Congress intended that anomaly.

CONCLUSION

The judgment of the court of appeals should be reversed.

Respectfully submitted.

DONALD B. VERRILLI, JR.
Solicitor General
KATHRYN KENEALLY
Assistant Attorney General
MALCOLM L. STEWART
Deputy Solicitor General
JOHN F. BASH
Assistant to the Solicitor General
GILBERT S. ROTHENBERG
RICHARD FARBER
ARTHUR T. CATTERALL
Attorneys

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APPENDIX

1. 26 U.S.C. 6221 provides:

Tax treatment determined at partnership level

Except as otherwise provided in this subchapter, the tax treatment of any partnership item (and the applicability of any penalty, addition to tax, or additional amount which relates to an adjustment to a partnership item) shall be determined at the partnership level.

2. 26 U.S.C. 6226 provides:

Judicial review of final partnership administrative adjustments

(a) Petition by tax matters partner

Within 90 days after the day on which a notice of a final partnership administrative adjustment is mailed to the tax matters partner, the tax matters partner may file a petition for a readjustment of the partnership items for such taxable year with—

(1) the Tax Court,

(2) the district court of the United States for the district in which the partnership's principal place of business is located, or

(3) the Court of Federal Claims.

(b) Petition by partner other than tax matters partner

(1) In general

If the tax matters partner does not file a readjustment petition under subsection (a) with respect to any final partnership administrative adjustment, any notice partner (and any 5-percent group) may, within 60 days after the close of the 90-day period set forth in subsection (a), file a petition for a readjustment of the partnership items for the taxable year involved with any of the courts described in subsection (a).

(2) Priority of the Tax Court action

If more than 1 action is brought under paragraph (1) with respect to any partnership for any partnership taxable year, the first such action brought in the Tax Court shall go forward.

(3) Priority outside the Tax Court

If more than 1 action is brought under paragraph (1) with respect to any partnership for any taxable year but no such action is brought in the Tax Court, the first such action brought shall go forward.

(4) Dismissal of other actions

If an action is brought under paragraph (1) in addition to the action which goes forward under paragraph (2) or (3), such action shall be dismissed.

(5) Treatment of premature petitions

If—

(A) a petition for a readjustment of partnership items for the taxable year involved is filed by a notice partner (or a 5-percent group) during the 90-day period described in subsection (a), and

(B) no action is brought under paragraph (1) during the 60-day period described therein with respect to such taxable year which is not dismissed,

such petition shall be treated for purposes of paragraph (1) as filed on the last day of such 60-day period.

(6) Tax matters partner may intervene

The tax matters partner may intervene in any action brought under this subsection.

(c) Partners treated as parties

If an action is brought under subsection (a) or (b) with respect to a partnership for any partnership taxable year—

(1) each person who was a partner in such partnership at any time during such year shall be treated as a party to such action, and

(2) the court having jurisdiction of such action shall allow each such person to participate in the action.

(d) Partner must have interest in outcome

(1) In order to be party to action

Subsection (c) shall not apply to a partner after the day on which—

(A) the partnership items of such partner for the partnership taxable year became non-partnership items by reason of 1 or more of the events described in subsection (b) of section 6231, or

(B) the period within which any tax attributable to such partnership items may be assessed against that partner expired.

Notwithstanding subparagraph (B), any person treated under subsection (c) as a party to an action shall be permitted to participate in such action (or file a readjustment petition under subsection (b) or paragraph (2) of this subsection) solely for the purpose of asserting that the period of limitations for assessing any tax attributable to partnership items has expired with respect to such person, and the court having jurisdiction of such action shall have jurisdiction to consider such assertion.

(2) To file petition

No partner may file a readjustment petition under subsection (b) unless such partner would (after the application of paragraph (1) of this subsection) be treated as a party to the proceeding.

(e) Jurisdictional requirement for bringing action in district court or Court of Federal Claims

(1) In general

A readjustment petition under this section may be filed in a district court of the United States or the Court of Federal Claims only if the partner filing the petition deposits with the Secretary, on or before the day the petition is filed, the amount by which the tax liability of the partner would be increased if the treatment of partnership items on the partner's return were made consistent with the treatment of partnership items on the partnership return, as adjusted by the final partnership administrative adjustment. In the case of a petition filed by a 5-percent group, the requirement of the preceding sentence shall apply to each member of the group. The court may by order provide that the jurisdictional requirements of this paragraph are satisfied where there has been a good faith attempt to satisfy such requirements and any shortfall in the amount required to be deposited is timely corrected.

(2) Refund on request

If an action brought in a district court of the United States or in the Court of Federal Claims is dismissed by reason of the priority of a Tax Court action under paragraph (2) of subsection (b), the Secretary shall, at the request of the partner who made the deposit, refund the amount deposited under paragraph (1).

(3) Interest payable

Any amount deposited under paragraph (1), while deposited, shall not be treated as a payment of tax for purposes of this title (other than chapter 67).

(f) Scope of judicial review

A court with which a petition is filed in accordance with this section shall have jurisdiction to determine all partnership items of the partnership for the partnership taxable year to which the notice of final partnership administrative adjustment relates, the proper allocation of such items among the partners, and the applicability of any penalty, addition to tax, or additional amount which relates to an adjustment to a partnership item.

(g) Determination of court reviewable

Any determination by a court under this section shall have the force and effect of a decision of the Tax Court or a final judgment or decree of the district court or the Court of Federal Claims, as the case may be, and shall be reviewable as such. With respect to the partnership, only the tax matters partner, a notice partner, or a 5-percent group may seek review of a determination by a court under this section.

(h) Effect of decision dismissing action

If an action brought under this section is dismissed (other than under paragraph (4) of subsection (b)), the decision of the court dismissing the action shall be considered as its decision that the notice of final part-

nership administrative adjustment is correct, and an appropriate order shall be entered in the records of the court.

3. 26 U.S.C. 6230 provides:

Additional administrative provisions

(a) Coordination with deficiency proceedings

(1) In general

Except as provided in paragraph (2) or (3), subchapter B of this chapter shall not apply to the assessment or collection of any computational adjustment.

(2) Deficiency proceedings to apply in certain cases

(A) Subchapter B shall apply to any deficiency attributable to—

(i) affected items which require partner level determinations (other than penalties, additions to tax, and additional amounts that relate to adjustments to partnership items), or

(ii) items which have become nonpartnership items (other than by reason of section 6231(b)(1)(C)) and are described in section 6231(e)(1)(B).

(B) Subchapter B shall be applied separately with respect to each deficiency described in

subparagraph (A) attributable to each partnership.

(C) Notwithstanding any other law or rule of law, any notice or proceeding under subchapter B with respect to a deficiency described in this paragraph shall not preclude or be precluded by any other notice, proceeding, or determination with respect to a partner's tax liability for a taxable year.

(3) Special rule in case of assertion by partner's spouse of innocent spouse relief

(A) Notwithstanding section 6404(b), if the spouse of a partner asserts that section 6013(e) applies with respect to a liability that is attributable to any adjustment to a partnership item (including any liability for any penalties, additions to tax, or additional amounts relating to such adjustment), then such spouse may file with the Secretary within 60 days after the notice of computational adjustment is mailed to the spouse a request for abatement of the assessment specified in such notice. Upon receipt of such request, the Secretary shall abate the assessment. Any reassessment of the tax with respect to which an abatement is made under this subparagraph shall be subject to the deficiency procedures prescribed by subchapter B. The period for making any such reassessment shall not expire before the expiration of 60 days after the date of such abatement.

(B) If the spouse files a petition with the Tax Court pursuant to section 6213 with respect to the request for abatement described in subparagraph (A), the Tax Court shall only have jurisdiction pursuant to this section to determine whether the requirements of section 6013(e) have been satisfied. For purposes of such determination, the treatment of partnership items (and the applicability of any penalties, additions to tax, or additional amounts) under the settlement, the final partnership administrative adjustment, or the decision of the court (whichever is appropriate) that gave rise to the liability in question shall be conclusive.

(C) Rules similar to the rules contained in subparagraphs (B) and (C) of paragraph (2) shall apply for purposes of this paragraph.

(b) Mathematical and clerical errors appearing on partnership return

(1) In general

Section 6225 shall not apply to any adjustment necessary to correct a mathematical or clerical error (as defined in section 6213(g)(2)) appearing on the partnership return.

(2) Exception

Paragraph (1) shall not apply to a partner if, within 60 days after the day on which notice of the correction of the error is mailed to the

partner, such partner files with the Secretary a request that the correction not be made.

(c) Claims arising out of erroneous computations, etc

(1) In general

A partner may file a claim for refund on the grounds that—

(A) the Secretary erroneously computed any computational adjustment necessary—

(i) to make the partnership items on the partner's return consistent with the treatment of the partnership items on the partnership return, or

(ii) to apply to the partner a settlement, a final partnership administrative adjustment, or the decision of a court in an action brought under section 6226 or section 6228(a),

(B) the Secretary failed to allow a credit or to make a refund to the partner in the amount of the overpayment attributable to the application to the partner of a settlement, a final partnership administrative adjustment, or the decision of a court in an action brought under section 6226 or section 6228(a), or

(C) the Secretary erroneously imposed any penalty, addition to tax, or additional

amount which relates to an adjustment to a partnership item.

(2) Time for filing claim

(A) Under paragraph (1)(A) or (C)

Any claim under subparagraph (A) or (C) of paragraph (1) shall be filed within 6 months after the day on which the Secretary mails the notice of computational adjustment to the partner.

(B) Under paragraph (1)(B)

Any claim under paragraph (1)(B) shall be filed within 2 years after whichever of the following days is appropriate:

(i) the day on which the settlement is entered into,

(ii) the day on which the period during which an action may be brought under section 6226 with respect to the final partnership administrative adjustment expires, or

(iii) the day on which the decision of the court becomes final.

(3) Suit if claim not allowed

If any portion of a claim under paragraph (1) is not allowed, the partner may bring suit with respect to such portion within the period specified in subsection (a) of section 6532 (relating to periods of limitations on refund suits).

(4) No review of substantive issues

For purposes of any claim or suit under this subsection, the treatment of partnership items on the partnership return, under the settlement, under the final partnership administrative adjustment, or under the decision of the court (whichever is appropriate) shall be conclusive. In addition, the determination under the final partnership administrative adjustment or under the decision of the court (whichever is appropriate) concerning the applicability of any penalty, addition to tax, or additional amount which relates to an adjustment to a partnership item shall also be conclusive. Notwithstanding the preceding sentence, the partner shall be allowed to assert any partner level defenses that may apply or to challenge the amount of the computational adjustment.

(5) Rules for seeking innocent spouse relief

(A) In general

The spouse of a partner may file a claim for refund on the ground that the Secretary failed to relieve the spouse under section 6015 from a liability that is attributable to an adjustment to a partnership item (including any liability for any penalties, additions to tax, or additional amounts relating to such adjustment).

(B) Time for filing claim

Any claim under subparagraph (A) shall be filed within 6 months after the day on which the

Secretary mails to the spouse the notice of computational adjustment referred to in subsection (a)(3)(A).

(C) Suit if claim not allowed

If the claim under subparagraph (B) is not allowed, the spouse may bring suit with respect to the claim within the period specified in paragraph (3).

(D) Prior determinations are binding

For purposes of any claim or suit under this paragraph, the treatment of partnership items (and the applicability of any penalties, additions to tax, or additional amounts) under the settlement, the final partnership administrative adjustment, or the decision of the court (whichever is appropriate) that gave rise to the liability in question shall be conclusive.

(d) Special rules with respect to credits or refunds attributable to partnership items

(1) In general

Except as otherwise provided in this subsection, no credit or refund of an overpayment attributable to a partnership item (or an affected item) for a partnership taxable year shall be allowed or made to any partner after the expiration of the period of limitation prescribed in section 6229 with respect to such partner for assessment of any tax attributable to such item.

(2) Administrative adjustment request

If a request for an administrative adjustment under section 6227 with respect to a partnership item is timely filed, credit or refund of any overpayment attributable to such partnership item (or an affected item) may be allowed or made at any time before the expiration of the period prescribed in section 6228 for bringing suit with respect to such request.

(3) Claim under subsection (c)

If a timely claim is filed under subsection (c) for a credit or refund of an overpayment attributable to a partnership item (or affected item), credit or refund of such overpayment may be allowed or made at any time before the expiration of the period specified in section 6532 (relating to periods of limitations on suits) for bringing suit with respect to such claim.

(4) Timely suit

Paragraph (1) shall not apply to any credit or refund of any overpayment attributable to a partnership item (or an item affected by such partnership item) if a partner brings a timely suit with respect to a timely administrative adjustment request under section 6228 or a timely claim under subsection (c) relating to such overpayment.

(5) Overpayments refunded without requirement that partner file claim

In the case of any overpayment by a partner which is attributable to a partnership item (or an affected item) and which may be refunded under this subchapter, to the extent practicable credit or refund of such overpayment shall be allowed or made without any requirement that the partner file a claim therefor.

(6) Subchapter B of chapter 66 not applicable

Subchapter B of chapter 66 (relating to limitations on credit or refund) shall not apply to any credit or refund of an overpayment attributable to a partnership item.

(e) Tax matters partner required to furnish names of partners to Secretary

If the Secretary mails to any partnership the notice specified in paragraph (1) of section 6223(a) with respect to any partnership taxable year, the tax matters partner shall furnish to the Secretary the name, address, profits interest, and taxpayer identification number of each person who was a partner in such partnership at any time during such taxable year. If the tax matters partner later discovers that the information furnished to the Secretary was incorrect or incomplete, the tax matters partner shall furnish such revised or additional information as may be necessary.

(f) Failure of tax matters partner, etc., to fulfill responsibility does not affect applicability of proceeding

The failure of the tax matters partner, a pass-thru partner, the representative of a notice group, or any other representative of a partner to provide any notice or perform any act required under this subchapter or under regulations prescribed under this subchapter on behalf of such partner does not affect the applicability of any proceeding or adjustment under this subchapter to such partner.

(g) Date decision of court becomes final

For purposes of section 6229(d)(1) and section 6230(c)(2)(B), the principles of section 7481(a) shall be applied in determining the date on which a decision of a district court or the Court of Federal Claims becomes final.

(h) Examination authority not limited

Nothing in this subchapter shall be construed as limiting the authority granted to the Secretary under section 7602.

(i) Time and manner of filing statements, making elections, etc.

Except as otherwise provided in this subchapter, each—

(1) statement,

(2) election,

(3) request, and

(4) furnishing of information,

shall be filed or made at such time, in such manner, and at such place as may be prescribed in regulations.

(j) Partnerships having principal place of business outside the United States

For purposes of sections 6226 and 6228, a principal place of business located outside the United States shall be treated as located in the District of Columbia.

(k) Regulations

The Secretary shall prescribe such regulations as may be necessary to carry out the purposes of this subchapter. Any reference in this subchapter to regulations is a reference to regulations prescribed by the Secretary.

***(l)* Court rules**

Any action brought under any provision of this subchapter shall be conducted in accordance with such rules of practice and procedure as may be prescribed by the Court in which the action is brought.

4. 26 U.S.C. 6231 provides:

Definitions and special rules

(a) Definitions

For purposes of this subchapter—

(1) Partnership

(A) In general

Except as provided in subparagraph (B), the term "partnership" means any partnership required to file a return under section 6031(a).

(B) Exception for small partnerships

(i) In general

The term "partnership" shall not include any partnership having 10 or fewer partners each of whom is an individual (other than a non-resident alien), a C corporation, or an estate of a deceased partner. For purposes of the preceding sentence, a husband and wife (and their estates) shall be treated as 1 partner.

(ii) Election to have subchapter apply

A partnership (within the meaning of subparagraph (A)) may for any taxable year elect to have clause (i) not apply. Such election shall apply for such taxable year and all subsequent taxable years

unless revoked with the consent of the Secretary.

(2) Partner

The term "partner" means—

(A) a partner in the partnership, and

(B) any other person whose income tax liability under subtitle A is determined in whole or in part by taking into account directly or indirectly partnership items of the partnership.

(3) Partnership item

The term "partnership item" means, with respect to a partnership, any item required to be taken into account for the partnership's taxable year under any provision of subtitle A to the extent regulations prescribed by the Secretary provide that, for purposes of this subtitle, such item is more appropriately determined at the partnership level than at the partner level.

(4) Nonpartnership item

The term "nonpartnership item" means an item which is (or is treated as) not a partnership item.

(5) Affected item

The term "affected item" means any item to the extent such item is affected by a partnership item.

(6) Computational adjustment

The term "computational adjustment" means the change in the tax liability of a partner which properly reflects the treatment under this subchapter of a partnership item. All adjustments required to apply the results of a proceeding with respect to a partnership under this subchapter to an indirect partner shall be treated as computational adjustments.

(7) Tax matters partner

The tax matters partner of any partnership is—

(A) the general partner designated as the tax matters partner as provided in regulations, or

(B) if there is no general partner who has been so designated, the general partner having the largest profits interest in the partnership at the close of the taxable year involved (or, where there is more than 1 such partner, the 1 of such partners whose name would appear first in an alphabetical listing).

If there is no general partner designated under subparagraph (A) and the Secretary determines that it is impracticable to apply subparagraph (B), the partner selected by the Secretary shall be treated as the tax matters partner. The Secretary shall, within 30 days of selecting a tax matters partner under the preceding sentence,

notify all partners required to receive notice under section 6223(a) of the name and address of the person selected.

(8) Notice partner

The term "notice partner" means a partner who, at the time in question, would be entitled to notice under subsection (a) of section 6223 (determined without regard to subsections (b)(2) and (e)(1)(B) thereof).

(9) Pass-thru partner

The term "pass-thru partner" means a partnership, estate, trust, S corporation, nominee, or other similar person through whom other persons hold an interest in the partnership with respect to which proceedings under this subchapter are conducted.

(10) Indirect partner

The term "indirect partner" means a person holding an interest in a partnership through 1 or more pass-thru partners.

(11) 5-percent group

A 5-percent group is a group of partners who for the partnership taxable year involved had profits interests which aggregated 5 percent or more.

(12) Husband and wife

Except to the extent otherwise provided in regulations, a husband and wife who have a joint

interest in a partnership shall be treated as 1 person.

(b) Items cease to be partnership items in certain cases

(1) In general

For purposes of this subchapter, the partnership items of a partner for a partnership taxable year shall become nonpartnership items as of the date—

(A) the Secretary mails to such partner a notice that such items shall be treated as nonpartnership items,

(B) the partner files suit under section 6228(b) after the Secretary fails to allow an administrative adjustment request with respect to any of such items,

(C) the Secretary or the Attorney General (or his delegate) enters into a settlement agreement with the partner with respect to such items, or

(D) such change occurs under subsection (e) of section 6223 (relating to effect of Secretary's failure to provide notice) or under subsection (c) of this section.

(2) Circumstances in which notice is permitted

The Secretary may mail the notice referred to in subparagraph (A) of paragraph (1) to a partner with respect to partnership items for a partnership taxable year only if—

(A) such partner—

(i) has complied with subparagraph (B) of section 6222(b)(1) (relating to notification of inconsistent treatment) with respect to one or more of such items, and

(ii) has not, as of the date on which the Secretary mails the notice, filed a request for administrative adjustments which would make the partner's treatment of the item or items with respect to which the partner complied with subparagraph (B) of section 6222(b)(1) consistent with the treatment of such item or items on the partnership return, or

(B)(i) such partner has filed a request under section 6227(d) for administrative adjustment of one or more of such items, and

(ii) the adjustments requested would not make such partner's treatment of such items consistent with the treatment of such items on the partnership return.

(3) Notice must be mailed before beginning of partnership proceeding

Any notice to a partner under subparagraph (A) of paragraph (1) with respect to partnership items for a partnership taxable year shall be mailed before the day on which the Secretary mails to the tax matters partner a notice of the

beginning of an administrative proceeding at the partnership level with respect to such items.

(c) Regulations with respect to certain special enforcement areas

(1) Applicability of subsection

This subsection applies in the case of—

(A) assessments under section 6851 (relating to termination assessments of income tax) or section 6861 (relating to jeopardy assessments of income, estate, gift, and certain excise taxes),

(B) criminal investigations,

(C) indirect methods of proof of income,

(D) foreign partnerships, and

(E) other areas that the Secretary determines by regulation to present special enforcement considerations.

(2) Items may be treated as nonpartnership items

To the extent that the Secretary determines and provides by regulations that to treat items as partnership items will interfere with the effective and efficient enforcement of this title in any case described in paragraph (1), such items shall be treated as nonpartnership items for purposes of this subchapter.

(3) Special rules

The Secretary may prescribe by regulation such special rules as the Secretary determines to be necessary to achieve the purposes of this subchapter in any case described in paragraph (1).

(d) Time for determining partner's profits interest in partnership

(1) In general

For purposes of section 6223(b) (relating to special rules for partnerships with more than 100 partners) and paragraph (11) of subsection (a) (relating to 5-percent group), the interest of a partner in the profits of a partnership for a partnership taxable year shall be determined—

(A) in the case of a partner whose entire interest in the partnership is disposed of during such partnership taxable year, as of the moment immediately before such disposition, or

(B) in the case of any other partner, as of the close of the partnership taxable year.

(2) Indirect partners

The Secretary shall prescribe regulations consistent with the principles of paragraph (1) to be applied in the case of indirect partners.

(e) Effect of judicial decisions in certain proceedings

(1) Determinations at partner level

No judicial determination with respect to the income tax liability of any partner not conducted under this subchapter shall be a bar to any adjustment in such partner's income tax liability resulting from—

(A) a proceeding with respect to partnership items under this subchapter, or

(B) a proceeding with respect to items which become nonpartnership items—

(i) by reason of 1 or more of the events described in subsection (b), and

(ii) after the appropriate time for including such items in any other proceeding with respect to nonpartnership items.

(2) Proceedings under section 6228(a)

No judicial determination in any proceeding under subsection (a) of section 6228 with respect to any partnership item shall be a bar to any adjustment in any other partnership item.

(f) Special rule for deductions, losses, and credits of foreign partnerships

Except to the extent otherwise provided in regulations, in the case of any partnership the tax matters partner of which resides outside the United States or the books of which are maintained outside the United States, no deduction,

loss, or credit shall be allowable to any partner unless section 6031 is complied with for the partnership's taxable year in which such deduction, loss, or credit arose at such time as the Secretary prescribes by regulations.

(g) Partnership return to be determinative of whether subchapter applies

(1) Determination that subchapter applies

If, on the basis of a partnership return for a taxable year, the Secretary reasonably determines that this subchapter applies to such partnership for such year but such determination is erroneous, then the provisions of this subchapter are hereby extended to such partnership (and its items) for such taxable year and to partners of such partnership.

(2) Determination that subchapter does not apply

If, on the basis of a partnership return for a taxable year, the Secretary reasonably determines that this subchapter does not apply to such partnership for such year but such determination is erroneous, then the provisions of this subchapter shall not apply to such partnership (and its items) for such taxable year or to partners of such partnership.

5. 26 U.S.C. 6233 provides:

Extension to entities filing partnership returns, etc.

(a) General rule

If a partnership return is filed by an entity for a taxable year but it is determined that the entity is not a partnership for such year, then, to the extent provided in regulations, the provisions of this subchapter are hereby extended in respect of such year to such entity and its items and to persons holding an interest in such entity.

(b) Similar rules in certain cases

If a partnership return is filed for any taxable year but it is determined that there is no entity for such taxable year, to the extent provided in regulations, rules similar to the rules of subsection (a) shall apply.

6. 26 U.S.C. 6662 (2000) provides:

Imposition of accuracy-related penalty

(a) Imposition of penalty

If this section applies to any portion of an underpayment of tax required to be shown on a return, there shall be added to the tax an amount equal to 20 percent of the portion of the underpayment to which this section applies.

(b) Portion of underpayment to which section applies

This section shall apply to the portion of any underpayment which is attributable to 1 or more of the

following:

(1) Negligence or disregard of rules or regulations.

(2) Any substantial understatement of income tax.

(3) Any substantial valuation misstatement under chapter 1.

(4) Any substantial overstatement of pension liabilities.

(5) Any substantial estate or gift tax valuation understatement.

This section shall not apply to any portion of an underpayment on which a penalty is imposed under section 6663.

(c) Negligence

For purposes of this section, the term "negligence" includes any failure to make a reasonable attempt to comply with the provisions of this title, and the term "disregard" includes any careless, reckless, or intentional disregard.

(d) Substantial understatement of income tax

(1) Substantial understatement

(A) In general

For purposes of this section, there is a substantial understatement of income tax for any taxable year if the amount of the under-

statement for the taxable year exceeds the greater of—

(i) 10 percent of the tax required to be shown on the return for the taxable year, or

(ii) $5,000.

(B) Special rule for corporations

In the case of a corporation other than an S corporation or a personal holding company (as defined in section 542), paragraph (1) shall be applied by substituting "$10,000" for "$5,000".

(2) Understatement

(A) In general

For purposes of paragraph (1), the term "understatement" means the excess of—

(i) the amount of the tax required to be shown on the return for the taxable year, over

(ii) the amount of the tax imposed which is shown on the return, reduced by any rebate (within the meaning of section 6211(b)(2)).

(B) Reduction for understatement due to position of taxpayer or disclosed item

The amount of the understatement under subparagraph (A) shall be reduced by that

portion of the understatement which is attributable to—

(i) the tax treatment of any item by the taxpayer if there is or was substantial authority for such treatment, or

(ii) any item if—

(I) the relevant facts affecting the item's tax treatment are adequately disclosed in the return or in a statement attached to the return, and

(II) there is a reasonable basis for the tax treatment of such item by the taxpayer.

For purposes of clause (ii)(II), in no event shall a corporation be treated as having a reasonable basis for its tax treatment of an item attributable to a multiple-party financing transaction if such treatment does not clearly reflect the income of the corporation.

(C) Special rules in cases involving tax shelters

(i) In general

In the case of any item of a taxpayer other than a corporation which is attributable to a tax shelter—

(I) subparagraph (B)(ii) shall not apply, and

(II) subparagraph (B)(i) shall not apply unless (in addition to meeting the requirements of such subparagraph) the taxpayer reasonably believed that the tax treatment of such item by the taxpayer was more likely than not the proper treatment.

(ii) Subparagraph (B) not to apply to corporations

Subparagraph (B) shall not apply to any item of a corporation which is attributable to a tax shelter.

(iii) Tax shelter

For purposes of this subparagraph, the term "tax shelter" means—

(I) a partnership or other entity,

(II) any investment plan or arrangement, or

(III) any other plan or arrangement,

if a significant purpose of such partnership, entity, plan, or arrangement is the avoidance or evasion of Federal income tax.

(D) Secretarial list

The Secretary shall prescribe (and revise not less frequently than annually) a list of positions—

(i) for which the Secretary believes there is not substantial authority, and

(ii) which affect a significant number of taxpayers.

Such list (and any revision thereof) shall be published in the Federal Register.

(e) Substantial valuation misstatement under chapter 1

(1) In general

For purposes of this section, there is a substantial valuation misstatement under chapter 1 if—

(A) the value of any property (or the adjusted basis of any property) claimed on any return of tax imposed by chapter 1 is 200 percent or more of the amount determined to be the correct amount of such valuation or adjusted basis (as the case may be), or

(B)(i) the price for any property or services (or for the use of property) claimed on any such return in connection with any transaction between persons described in section 482 is 200 percent or more (or 50 percent or less) of the amount determined under section 482 to be the correct amount of such price, or

(ii) the net section 482 transfer price adjustment for the taxable year exceeds the

lesser of $5,000,000 or 10 percent of the taxpayer's gross receipts.

(2) Limitation

No penalty shall be imposed by reason of subsection (b)(3) unless the portion of the underpayment for the taxable year attributable to substantial valuation misstatements under chapter 1 exceeds $5,000 ($10,000 in the case of a corporation other than an S corporation or a personal holding company (as defined in section 542)).

(3) Net section 482 transfer price adjustment

For purposes of this subsection—

(A) In general

The term "net section 482 transfer price adjustment" means, with respect to any taxable year, the net increase in taxable income for the taxable year (determined without regard to any amount carried to such taxable year from another taxable year) resulting from adjustments under section 482 in the price for any property or services (or for the use of property).

(B) Certain adjustments excluded in determining threshold

For purposes of determining whether the threshold requirements of paragraph (1)(B)(ii) are met, the following shall be excluded:

(i) Any portion of the net increase in taxable income referred to in subparagraph (A) which is attributable to any redetermination of a price if—

(I) it is established that the taxpayer determined such price in accordance with a specific pricing method set forth in the regulations prescribed under section 482 and that the taxpayer's use of such method was reasonable,

(II) the taxpayer has documentation (which was in existence as of the time of filing the return) which sets forth the determination of such price in accordance with such a method and which establishes that the use of such method was reasonable, and

(III) the taxpayer provides such documentation to the Secretary within 30 days of a request for such documentation.

(ii) Any portion of the net increase in taxable income referred to in subparagraph (A) which is attributable to a redetermination of price where such price was not determined in accordance with such a specific pricing method if—

(I) the taxpayer establishes that none of such pricing methods was likely to result in a price that would clearly reflect income, the taxpayer used another pricing method to determine such price, and such other pricing method was likely to result in a price that would clearly reflect income,

(II) the taxpayer has documentation (which was in existence as of the time of filing the return) which sets forth the determination of such price in accordance with such other method and which establishes that the requirements of subclause (I) were satisfied, and

(III) the taxpayer provides such documentation to the Secretary within 30 days of request for such documentation.

(iii) portion of such net increase which is attributable to any transaction solely between foreign corporations

unless, in the case of any such corporations, the treatment of such transaction affects the determination of income from sources within the United States or taxable income effectively connected with the conduct of a trade or business within the United States.

(C) Special rule

If the regular tax (as defined in section 55(c)) imposed by chapter 1 on the taxpayer is determined by reference to an amount other than taxable income, such amount shall be treated as the taxable income of such taxpayer for purposes of this paragraph.

(D) Coordination with reasonable cause exception

For purposes of section 6664(c) the taxpayer shall not be treated as having reasonable cause for any portion of an underpayment attributable to a net section 482 transfer price adjustment unless such taxpayer meets the requirements of clause (i), (ii), or (iii) of subparagraph (B) with respect to such portion.

(f) Substantial overstatement of pension liabilities

(1) In general

For purposes of this section, there is a substantial overstatement of pension liabilities if the actuarial determination of the liabilities taken into account for purposes of computing the deduction under paragraph (1) or (2) of section 404(a) is 200 percent or more of the amount determined to be the correct amount of such liabilities.

(2) Limitation

No penalty shall be imposed by reason of subsection (b)(4) unless the portion of the underpayment for the taxable year attributable to substantial overstatements of pension liabilities exceeds $1,000.

(g) Substantial estate or gift tax valuation understatement

(1) In general

For purposes of this section, there is a substantial estate or gift tax valuation understatement if the value of any property claimed on any return of tax imposed by subtitle B is 50 percent or less of the amount determined to be the correct amount of such valuation.

(2) Limitation

No penalty shall be imposed by reason of subsection (b)(5) unless the portion of the underpayment attributable to substantial estate or gift tax

valuation understatements for the taxable period (or, in the case of the tax imposed by chapter 11, with respect to the estate of the decedent) exceeds $5,000.

(h) Increase in penalty in case of gross valuation misstatements

(1) In general

To the extent that a portion of the underpayment to which this section applies is attributable to one or more gross valuation misstatements, subsection (a) shall be applied with respect to such portion by substituting "40 percent" for "20 percent".

(2) Gross valuation misstatements

The term "gross valuation misstatements" means—

(A) any substantial valuation misstatement under chapter 1 as determined under subsection (e) by substituting—

(i) "400 percent" for "200 percent" each place it appears,

(ii) "25 percent" for "50 percent", and

(iii) in paragraph (1)(B)(ii)—

(I) "$20,000,000" for "$5,000,000", and

(II) "20 percent" for "10 percent".

(B) any substantial overstatement of pension liabilities as determined under subsection (f) by substituting "400 percent" for "200 percent", and

(C) any substantial estate or gift tax valuation understatement as determined under subsection (g) by substituting "25 percent" for "50 percent".

7. 26 C.F.R. 1.6662-5 provides:

Substantial and gross valuation misstatements under chapter 1.

(a) *In general.* If any portion of an underpayment, as defined in section 6664(a) and § 1.6664-2, of any income tax imposed under chapter 1 of subtitle A of the Code that is required to be shown on a return is attributable to a substantial valuation misstatement under chapter 1 ("substantial valuation misstatement"), there is added to the tax an amount equal to 20 percent of such portion. Section 6662(h) increases the penalty to 40 percent in the case of a gross valuation misstatement under chapter 1 ("gross valuation misstatement"). No penalty under section 6662(b)(3) is imposed, however, on a portion of an underpayment that is attributable to a substantial or gross valuation misstatement unless the aggregate of all portions of the underpayment attributable to substantial or gross

valuation misstatements exceeds the applicable dollar limitation ($5,000 or $10,000), as provided in section 6662(e)(2) and paragraphs (b) and (f)(2) of this section. This penalty also does not apply to the extent that the reasonable cause and good faith exception to this penalty set forth in § 1.6664–4 applies. There is no disclosure exception to this penalty.

(b) *Dollar limitation.* No penalty may be imposed under section 6662(b)(3) for a taxable year unless the portion of the underpayment for that year that is attributable to substantial or gross valuation misstatements exceeds $5,000 ($10,000 in the case of a corporation other than an S corporation (as defined in section 1361(a)(1)) or a personal holding company (as defined in section 542)). This limitation is applied separately to each taxable year for which there is a substantial or gross valuation misstatement.

(c) *Special rules in the case of carrybacks and carryovers*—(1) *In general.* The penalty for a substantial or gross valuation misstatement applies to any portion of an underpayment for a year to which a loss, deduction or credit is carried that is attributable to a substantial or gross valuation misstatement for the year in which the carryback or carryover of the loss, deduction or credit arises (the "loss or credit year"), provided that the applicable dollar limitation set forth in section 6662(e)(2) is satisfied in the carryback or carryover year.

(2) *Transition rule for carrybacks to pre-1990 years.* The penalty under section 6662(b)(3) is im-

posed on any portion of an underpayment for a carryback year, the return for which is due (without regard to extensions) before January 1, 1990, if—

(i) That portion is attributable to a substantial or gross valuation misstatement for a loss or credit year; and

(ii) The return for the loss or credit year is due (without regard to extensions) after December 31, 1989.

The preceding sentence applies only if the underpayment for the carryback year exceeds the applicable dollar limitation ($5,000, or $10,000 for most corporations). See *Example 3* in paragraph (d) of this section.

(d) *Examples.* The following examples illustrate the provisions of paragraphs (b) and (c) of this section. These examples do not take into account the reasonable cause exception under § 1.6664–4.

Example 1. Corporation Q is a C corporation. In 1990, the first year of its existence, Q had taxable income of $200,000 without considering depreciation of a particular asset. On its calendar year 1990 return, Q overstated its basis in this asset by an amount that caused a substantial valuation misstatement. The overstated basis resulted in depreciation claimed of $350,000, which was $250,000 more than the $100,000 allowable. Thus, on its 1990 return, Q showed a loss of $150,000. In 1991, Q had taxable income of $450,000 before application of the loss carryover, and

Q claimed a carryover loss deduction under section 172 of $150,000, resulting in taxable income of $300,000 for 1991. Upon audit of the 1990 return, the basis of the asset was corrected, resulting in an adjustment of $250,000. For 1990, the underpayment resulting from the $100,000 taxable income (- $150,000+$250,000) is attributable to the valuation misstatement. Assuming the underpayment resulting from the $100,000 taxable income exceeds the $10,000 limitation, the penalty will be imposed in 1990. For 1991, the elimination of the loss carryover results in additional taxable income of $150,000. The underpayment for 1991 resulting from that adjustment is also attributable to the substantial valuation misstatement on the 1990 return. Assuming the underpayment resulting from the $150,000 additional taxable income for 1991 exceeds the $10,000 limitation, the substantial valuation misstatement penalty also will be imposed for that year.

Example 2. (i) Corporation T is a C corporation. In 1990, the first year of its existence, T had a loss of $3,000,000 without considering depreciation of its major asset. On its calendar year 1990 return, T overstated its basis in this asset in an amount that caused a substantial valuation misstatement. This overstatement resulted in depreciation claimed of $3,500,000, which was $2,500,000 more than the $1,000,000 allowable. Thus, on its 1990 return, T showed a loss of $6,500,000. In 1991, T had taxable income of $4,500,000 before application of the carryover loss, but claimed a carryover loss deduction under

section 172 in the amount of $4,500,000, resulting in taxable income of zero for that year and leaving a $2,000,000 carryover available. Upon audit of the 1990 return, the basis of the asset was corrected, resulting in an adjustment of $2,500,000.

(ii) For 1990, the underpayment is still zero (- $6,500,000+$2,500,000= -$4,000,000). Thus, the penalty does not apply in 1990. The loss for 1990 is reduced to $4,000,000.

(iii) For 1991, there is additional taxable income of $500,000 as a result of the reduction of the carryover loss ($4,500,000 reported income before carryover loss minus corrected carryover loss of $4,000,000= $500,000). The underpayment for 1991 resulting from reduction of the carryover loss is attributable to the valuation misstatement on the 1990 return. Assuming the underpayment resulting from the $500,000 additional taxable income exceeds the $10,000 limitation, the substantial valuation misstatement penalty will be imposed in 1991.

Example 3. Corporation V is a C corporation. In 1990, V had a loss of $100,000 without considering depreciation of a particular asset which it had fully depreciated in earlier years. V had a depreciable basis in the asset of zero, but on its 1990 calendar year return erroneously claimed a basis in the asset of $1,250,000 and depreciation of $250,000. V reported a $350,000 loss for the year 1990, and carried back the loss to the 1987 and 1988 tax years. V had reported taxable income of $300,000 in 1987 and $200,000 in

1988, before application of the carryback. The $350,000 carryback eliminated all taxable income for 1987, and $50,000 of the taxable income for 1988. After disallowance of the $250,000 depreciation deduction for 1990, V still had a loss of $100,000. Because there is no underpayment for 1990, no valuation misstatement penalty is imposed for 1990. However, as a result of the 1990 depreciation adjustment, the carryback to 1987 is reduced from $350,000 to $100,000. After absorption of the $100,000 carryback, V has taxable income of $200,000 for 1987. This adjustment results in an underpayment for 1987 that is attributable to the valuation misstatement on the 1990 return. The valuation misstatement for 1990 is a gross valuation misstatement because the correct adjusted basis of the depreciated asset was zero. (See paragraph (e)(2) of this section.) Therefore, the 40 percent penalty rate applies to the 1987 underpayment attributable to the 1990 misstatement, provided that this underpayment exceeds $10,000. The adjustment also results in the elimination of any loss carryback to 1988 resulting in an increase in taxable income for 1988 of $50,000. Assuming the underpayment resulting from this additional $50,000 of income exceeds $10,000, the gross valuation misstatement penalty is imposed on the underpayment for 1988.

(e) *Definitions.* (1) *Substantial valuation misstatement.* There is a substantial valuation misstatement if the value or adjusted basis of any property claimed on a return of tax imposed under chapter 1 is 200 percent or more of the correct amount.

(2) *Gross valuation misstatement.* There is a gross valuation misstatement if the value or adjusted basis of any property claimed on a return of tax imposed under chapter 1 is 400 percent or more of the correct amount.

(3) *Property.* For purposes of this section, the term "property" refers to both tangible and intangible property. Tangible property includes property such as land, buildings, fixtures and inventory. Intangible property includes property such as goodwill, covenants not to compete, leaseholds, patents, contract rights, debts and choses in action.

(f) *Multiple valuation misstatements on a return* —(1) *Determination of whether valuation misstatements are substantial or gross* The determination of whether there is a substantial or gross valuation misstatement on a return is made on a property-by-property basis. Assume, for example, that property A has a value of 60 but a taxpayer claims a value of 110, and that property B has a value of 40 but the taxpayer claims a value of 100. Because the claimed and correct values are compared on a property-by-property basis, there is a substantial valuation misstatement with respect to property B, but not with respect to property A, even though the claimed values (210) are 200 percent or more of the correct values (100) when compared on an aggregate basis.

(2) *Application of dollar limitation.* For purposes of applying the dollar limitation set forth in section 6662(e)(2), the determination of the portion of an un-

derpayment that is attributable to a substantial or gross valuation misstatement is made by aggregating all portions of the underpayment attributable to substantial or gross valuation misstatements. Assume, for example, that the value claimed for property C on a return is 250 percent of the correct value, and that the value claimed for property D on the return is 400 percent of the correct value. Because the portions of an underpayment that are attributable to a substantial or gross valuation misstatement on a return are aggregated in applying the dollar limitation, the dollar limitation is satisfied if the portion of the underpayment that is attributable to the misstatement of the value of property C, when aggregated with the portion of the underpayment that is attributable to the misstatement of the value of property D, exceeds $5,000 ($10,000 in the case of most corporations).

(g) *Property with a value or adjusted basis of zero.* The value or adjusted basis claimed on a return of any property with a correct value or adjusted basis of zero is considered to be 400 percent or more of the correct amount. There is a gross valuation misstatement with respect to such property, therefore, and the applicable penalty rate is 40 percent.

(h) *Pass-through entities—(1) In general.* The determination of whether there is a substantial or gross valuation misstatement in the case of a return of a pass-through entity (as defined in § 1.6662-4(f)(5)) is made at the entity level. However, the dollar limitation ($5,000 or $10,000, as the case may be) is applied at the taxpayer level (*i.e.*, with respect to the return of

the shareholder, partner, beneficiary, or holder of a residual interest in a REMIC).

(2) *Example*

The rules of paragraph (h)(1) of this section may be illustrated by the following example.

Example. Partnership P has two partners, individuals A and B. P claims a $40,000 basis in a depreciable asset which, in fact, has a basis of $15,000. The determination that there is a substantial valuation misstatement is made solely with reference to P by comparing the $40,000 basis claimed by P with P's correct basis of $15,000. However, the determination of whether the $5,000 threshold for application of the penalty has been reached is made separately for each partner. With respect to partner A, the penalty will apply if the portion of A's underpayment attributable to the passthrough of the depreciation deduction, when aggregated with any other portions of A's underpayment also attributable to substantial or gross valuation misstatements, exceeds $5,000 (assuming there is not reasonable cause for the misstatements (*see* § 1.6664–4(c)).

(i) [Reserved]

(j) *Transactions between persons described in section 482 and net section 482 transfer price adjustments.* [Reserved]

(k) *Returns affected.* Except in the case of rules relating to transactions between persons described in section 482 and net sections 482 transfer price adjust-

ments, the provisions of section 6662(b)(3) apply to returns due (without regard to extensions of time to file) after December 31, 1989, notwithstanding that the original substantial or gross valuation misstatement occurred on a return that was due (without regard to extensions) before January 1, 1990. Assume, for example, that a calendar year corporation claimed a deduction on its 1990 return for depreciation of an asset with a basis of X. Also assume that it had reported the same basis for computing depreciation on its returns for the preceding 5 years and that the basis shown on the return each year was 200 percent or more of the correct basis. The corporation may be subject to a penalty for substantial valuation misstatements on its 1989 and 1990 returns, even though the original misstatement occurred prior to the effective date of sections 6662(b)(3) and (e).

8. 26 C.F.R. 301.6221-1 provides:

Tax treatment determined at partnership level.

(a) *In general.* A partner's treatment of partnership items on the partner's return may not be changed except as provided in sections 6222 through 6231 and the regulations thereunder. Thus, for example, if a partner treats an item on the partner's return consistently with the treatment of the item on the partnership return, the IRS generally cannot adjust the treatment of that item on the partner's return except through a partnership-level proceeding. Similarly,

the taxpayer may not put partnership items in issue in a proceeding relating to nonpartnership items. For example, the taxpayer may not offset a potential increase in taxable income based on changes to nonpartnership items by a potential decrease based on partnership items.

(b) *Restrictions inapplicable after items become nonpartnership items.* Section 6221 and paragraph (a) of this section cease to apply to items arising from a partnership with respect to a partner when those items cease to be partnership items with respect to that partner under section 6231(b).

(c) *Penalties determined at partnership level.* Any penalty, addition to tax, or additional amount that relates to an adjustment to a partnership item shall be determined at the partnership level. Partner-level defenses to such items can only be asserted through refund actions following assessment and payment. Assessment of any penalty, addition to tax, or additional amount that relates to an adjustment to a partnership item shall be made based on partnership-level determinations. Partnership-level determinations include all the legal and factual determinations that underlie the determination of any penalty, addition to tax, or additional amount, other than partner-level defenses specified in paragraph (d) of this section.

(d) *Partner-level defenses.* Partner-level defenses to any penalty, addition to tax, or additional amount that relates to an adjustment to a partnership item may not be asserted in the partnership-level proceed-

ing, but may be asserted through separate refund actions following assessment and payment. See section 6230(c)(4). Partner-level defenses are limited to those that are personal to the partner or are dependent upon the partner's separate return and cannot be determined at the partnership level. Examples of these determinations are whether any applicable threshold underpayment of tax has been met with respect to the partner or whether the partner has met the criteria of section 6664(b) (penalties applicable only where return is filed), or section 6664(c)(1) (reasonable cause exception) subject to partnership-level determinations as to the applicability of section 6664(c)(2).

(e) *Cross-references.* See §§ 301.6231(c)-1 and 301.6231(c)-2 for special rules relating to certain applications and claims for refund based on losses, deductions, or credits from abusive tax shelter partnerships.

(f) *Effective date.* This section is applicable to partnership taxable years beginning on or after October 4, 2001. For years beginning prior to October 4, 2001, see § 301.6221–1T contained in 26 CFR part 1, revised April 1, 2001.

9. 26 C.F.R. 301.6231(a)(3)-1 provides:

Partnership items.

(a) *In general.* For purposes of subtitle F of the Internal Revenue Code of 1954, the following items which are required to be taken into account for the taxable year of a partnership under subtitle A of the Code are more appropriately determined at the partnership level than at the partner level and, therefore, are partnership items:

(1) The partnership aggregate and each partner's share of each of the following:

(i) Items of income, gain, loss, deduction, or credit of the partnership;

(ii) Expenditures by the partnership not deductible in computing its taxable income (for example, charitable contributions);

(iii) Items of the partnership which may be tax preference items under section 57(a) for any partner;

(iv) Income of the partnership exempt from tax;

(v) Partnership liabilities (including determinations with respect to the amount of the liabilities, whether the liabilities are nonrecourse, and changes from the preceding taxable year); and

(vi) Other amounts determinable at the partnership level with respect to partnership assets, investments, transactions and operations necessary to enable the partnership or the partners to determine—

(A) The investment credit determined under section 46(a);

(B) Recapture under section 47 of the investment credit;

(C) Amounts at risk in any activity to which section 465 applies;

(D) The depletion allowance under section 613A with respect to oil and gas wells; and

(E) The application of section 751 (a) and (b);

(2) Guaranteed payments;

(3) Optional adjustments to the basis of partnership property pursuant to an election under section 754 (including necessary preliminary determinations, such as the determination of a transferee partner's basis in a partnership interest); and

(4) Items relating to the following transactions, to the extent that a determination of such items can be made from determinations that the partnership is required to make with respect to an amount, the character of an amount, or the percentage interest of a partner in the partnership, for purposes of the partnership books and records or for purposes of furnishing information to a partner:

(i) Contributions to the partnership;

(ii) Distributions from the partnership; and

(iii) Transactions to which section 707(a) applies (including the application of section 707(b)).

(b) *Factors that affect the determination of partnership items.* The term "partnership item" includes the accounting practices and the legal and factual determinations that underlie the determination of the amount, timing, and characterization of items of income, credit, gain, loss, deduction, etc. Examples of these determinations are: The partnership's method of accounting, taxable year, and inventory method; whether an election was made by the partnership; whether partnership property is a capital asset, section 1231 property, or inventory; whether an item is currently deductible or must be capitalized; whether partnership activities have been engaged in with the intent to make a profit for purposes of section 183; and whether the partnership qualifies for the research and development credit under section 30.

(c) *Illustrations*—(1) *In general.* This paragraph (c) illustrates the provisions of paragraph (a)(4) of this section. The determinations illustrated in this paragraph (c) that the partnership is required to make are not exhaustive; there may be additional determinations that the partnership is required to make which relate to a transaction listed in paragraph (a)(4) of this section. The critical element is that the partnership needs to make a determination with respect to a matter for the purposes stated; failure by the partnership actually to make a determination (for example, because it does not maintain proper books and records) does not prevent an item from being a partnership item.

(2) *Contributions.* For purposes of its books and records, or for purposes of furnishing information to a partner, the partnership needs to determine:

(i) The character of the amount received from a partner (for example, whether it is a contribution, a loan, or a repayment of a loan);

(ii) The amount of money contributed by a partner;

(iii) The applicability of the investment company rules of section 721(b) with respect to a contribution; and

(iv) The basis to the partnership of contributed property (including necessary preliminary determinations, such as the partner's basis in the contributed property).

To the extent that a determination of an item relating to a contribution can be made from these and similar determinations that the partnership is required to make, therefore, that item is a partnership item. To the extent that that determination requires other information, however, that item is not a partnership item. For example, it may be necessary to determine whether contribution of the property causes recapture by the contributing partner of the investment credit under section 47 in certain circumstances in which that determination is irrelevant to the partnership.

(3) *Distributions.* For purposes of its books and records, or for purposes of furnishing information to a partner, the partnership needs to determine:

(i) The character of the amount transferred to a

partner (for example, whether it is a distribution, a loan, or a repayment of a loan);

(ii) The amount of money distributed to a partner;

(iii) The adjusted basis to the partnership of distributed property; and

(iv) The character of partnership property (for example, whether an item is inventory or a capital asset).

To the extent that a determination of an item relating to a distribution can be made from these and similar determinations that the partnership is required to make, therefore, that item is a partnership item. To the extent that that determination requires other information, however, that item is not a partnership item. Such other information would include those factors used in determining the partner's basis for the partnership interest that are not themselves partnership items, such as the amount that the partner paid to acquire the partnership interest from a transferor partner if that transfer was not covered by an election under section 754.

(4) *Transactions to which section 707 (a) applies.* For purposes of its books and records, the partnership needs to determine:

(i) The amount transferred from the partnership to a partner or from a partner to the partnership in any transaction to which section 707(a) applies;

(ii) The character of such an amount (for example, whether or not it is a loan; in the case of amounts paid

over time for the purchase of an asset, what portion is interest); and

(iii) The percentage of the capital interests and profits interests in the partnership owned by each partner.

To the extent that a determination of an item relating to a transaction to which section 707(a) applies can be made from these and similar determinations that the partnership is required to make, therefore, that item is a partnership item. To the extent that that determination requires other information, however, that item is not a partnership item. An example of such other information is the cost to the partner of goods sold to the partnership.

(d) *Effective date.* This section shall apply with respect to partnership taxable years beginning after September 3, 1982. This section shall also apply with respect to any partnership taxable year ending after September 3, 1982, if with respect to that year there is an agreement entered into pursuant to section 407(a)(3) of the Tax Equity and Fiscal Responsibility Act of 1982.

10. 26 C.F.R. 301.6231(a)(5)-1 provides:

Definition of affected item.

(a) *In general.* The term *affected item* means any item to the extent such item is affected by a partnership item. It includes items unrelated to the items reflected on the partnership return (for example, an

item, such as the threshold for the medical expense deduction under section 213, that varies if there is a change in an individual partner's adjusted gross income).

(b) *Basis in a partner's partnership interest.* The basis of a partner's partnership interest is an affected item to the extent it is not a partnership item.

(c) *At-risk limitation.* The application of the at-risk limitation under section 465 to a partner with respect to a loss incurred by a partnership is an affected item to the extent it is not a partnership item.

(d) *Passive losses.* The application of the passive loss rules under section 469 to a partner with respect to a loss incurred by a partnership is an affected item to the extent it is not a partnership item.

(e) *Penalty, addition to tax, or additional amount.*—(1) In general. The term affected item includes any penalty, addition to tax, or additional amount provided by subchapter A of chapter 68 of the Internal Revenue Code of 1986 to the extent provided in this paragraph (e).

(2) *Penalty, addition to tax, or additional amount without floor.* If a penalty, addition to tax, or additional amount that does not contain a floor (that is, a threshold amount of underpayment or understatement necessary before the imposition of the penalty, addition to tax, or additional amount) is imposed on a partner as the result of an adjustment to a partnership item, the term *affected item* shall include the penalty,

addition to tax, or additional amount computed with reference to the portion of the underpayment that is attributable to the partnership item adjustment(s) to which the penalty, addition to tax, or additional amount applies.

(3) *Penalty, addition to tax, or additional amount containing floor*—(i) *Floor exceeded prior to adjustment.* If a partner would have been subject to a penalty, addition to tax, or additional amount that contains a floor in the absence of an adjustment to a partnership item (that is, the partner's understatement or underpayment exceeded the floor even without an adjustment to a partnership item) the term *affected item* shall include only the portion of the penalty, addition to tax, or additional amount computed with reference to the partnership item (or affected item) adjustments.

(ii) *Floor not exceeded prior to adjustment.* In the case of a penalty, addition to tax, or additional amount that contains a floor, if the taxpayer's understatement or underpayment does not exceed the floor prior to an adjustment to a partnership item but does so after such adjustment, the term *affected item* shall include the penalty, addition to tax, or additional amount computed with reference to the entire underpayment or understatement to which the penalty, addition to tax, or additional amount applies.

(4) *Examples.*—The provisions of this paragraph (e) may be illustrated by the following examples:

Example 1. A, a partner of P, had an aggregate underpayment of $1,000 of which $100 is attributable to an adjustment to partnership items. A is negligent in reporting the partnership items. The accuracy-related penalty under section 6662 for negligence computed with reference to the $100 underpayment attributable to the partnership item adjustments is an affected item.

Example 2. B, a partner of P, understated B's income tax liability attributable to nonpartnership items by $6,000. An adjustment to a partnership item resulting from a partnership proceeding increased B's income tax by an additional $2,000. Prior to the adjustment, B would have been subject to the accuracy-related penalty under section 6662 for a substantial understatement of income tax with respect to the $6,000 understatement attributable to nonpartnership items. The portion of the accuracy-related penalty under section 6662 computed with reference to the $2,000 understatement attributable to partnership items to which the accuracy-related penalty applies is an affected item. The portion of the accuracy-related penalty under section 6662 computed with reference to the $6,000 pre-existing understatement is not an affected item.

Example 3. C, a partner in partnership P, understated C's income tax liability attributable to nonpartnership items by $4,000. As a result of an adjustment to partnership items, that understatement is increased to $10,000. Prior to the adjustment, C would not have been subject to the accuracy-related penalty under section 6662 for a substantial understatement of income tax. The accuracy-related penalty under section 6662 computed with reference to the entire $10,000 understatement to which the accuracy-related penalty applies is an affected item.

(f) *Effective date.* This section is applicable to partnership taxable years beginning on or after October 4, 2001. For years beginning prior to October 4, 2001, see § 301.6231(a)(5)-1T contained in 26 CFR part 1, revised April 1, 2001.

11. 26 C.F.R. 301.6231(a)(6)-1 provides:

Computational adjustments.

(a) *Changes in a partner's tax liability*—(1) *In general.* A change in the tax liability of a partner to properly reflect the treatment of a partnership item under subchapter C of chapter 63 of the Internal Revenue Code is made through a computational adjustment. A computational adjustment includes a change in tax liability that reflects a change in an affected item where that change is necessary to properly reflect the treatment of a partnership item, or any penalty, addition to tax, or additional amount that relates

to an adjustment to a partnership item. However, if a change in a partner's tax liability cannot be made without making one or more partner-level determinations, that portion of the change in tax liability attributable to the partner-level determinations shall be made under the deficiency procedures (as described in subchapter B of chapter 63 of the Internal Revenue Code), except for any penalty, addition to tax, or additional amount that relates to an adjustment to a partnership item.

(2) *Affected items that do not require partner-level determinations.* Changes in a partner's tax liability with respect to affected items that do not require partner-level determinations (such as the threshold amount of medical deductions under section 213 that changes as the result of determinations made at the partnership level) are computational adjustments that are directly assessed. When making computational adjustments, the Internal Revenue Service may assume that amounts the partner reported on the partner's individual return include all amounts reported to the partner by the partnership (on the Schedule K–1s attached to the partnership's original return), absent contrary notice to the Internal Revenue Service (for example, a "Notice of Inconsistent Treatment" pursuant to § 301.6222(a)-2(c)). Such an assumption by the Internal Revenue Service does not constitute a partner-level determination. Moreover, substituting redetermined partnership items for the partner's previously reported partnership items (including partnership items included in carryover amounts) does not

constitute a partner-level determination where the Internal Revenue Service otherwise accepts, for the sole purpose of determining the computational adjustment, all nonpartnership items (including, for example, nonpartnership item components of carryover amounts) as reported.

(3) *Affected items that require partner-level determinations.* Changes in a partner's tax liability with respect to affected items that require partner-level determinations (such as a partner's at-risk amount to the extent it depends upon the source from which the partner obtained the funds that the partner contributed to the partnership) are computational adjustments that are subject to the deficiency procedures. Notwithstanding the preceding sentence, any penalty, addition to tax, or additional amount that relates to an adjustment to a partnership item is not subject to the deficiency procedures, but rather may be directly assessed as part of the computational adjustment that is made following the partnership proceeding, based on determinations in that proceeding, regardless of whether any partner-level determinations may be required.

(b) *Interest.* A computational adjustment includes any interest due with respect to any underpayment or overpayment of tax attributable to adjustments to reflect properly the treatment of partnership items.

(c) *Effective date.* This section is applicable to partnership taxable years beginning on or after Octo-

ber 4, 2001. For years beginning prior to October 4, 2001, see § 301.6231(a)(6)-1T contained in 26 CFR part 1, revised April 1, 2001.

RESPONDENT'S BRIEF

RECORD
AND
BRIEFS

Supreme Court, U.S.
FILED
JUL 19 2013
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No. 12-562

In the Supreme Court of the United States

UNITED STATES OF AMERICA,
Petitioner,

v.

GARY WOODS, AS TAX MATTERS PARTNER OF TESORO DRIVE PARTNERS, ET AL.,
Respondents.

ON WRIT OF CERTIORARI TO THE
UNITED STATES COURT OF APPEALS
FOR THE FIFTH CIRCUIT

BRIEF FOR RESPONDENTS

JOEL N. CROUCH
MEADOWS, COLLIER,
REED, COUSINS, CROUCH
& UNGERMAN LLP
901 Main Street
Suite 3700
Dallas, TX 75202

GREGORY G. GARRE
Counsel of Record
BRIAN D. SCHMALZBACH
KATYA S. CRONIN
LATHAM & WATKINS LLP
555 Eleventh Street, NW
Suite 1000
Washington, DC 20004
(202) 637-2207
gregory.garre@lw.com

Counsel for Respondents

Library of Congress
Law Library

QUESTIONS PRESENTED

1. Whether the district court had jurisdiction in this case under 26 U.S.C. § 6226 to consider the substantial valuation misstatement penalty.

2. Whether the substantial valuation misstatement penalty in 26 U.S.C. § 6662 applies when a transaction is disregarded because of a legal determination that the transaction lacks economic substance.

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INTRODUCTION

The government challenges the court of appeals' conclusion that the valuation misstatement penalty (26 U.S.C. § 6662(h)) does not apply where a tax underpayment is triggered by a legal determination that a transaction should be disregarded for lack of economic substance rather than a finding that the taxpayer inaccurately reported the price or cost of an item—*i.e.*, made a *valuation* misstatement. That challenge should be rejected. The text, history, and structure of the penalty establish that Congress intended to penalize "valuation misstatements." That is, what the government itself calls (at 41) the "run-of-the-mill case in which a taxpayer simply overstates the value or purchase price of an asset," an error that frequently impacts the cost, or basis, of tax items as well. Congress did not enact the quite different "basis-overstatement penalty" minted by the government in its brief, which the Internal Revenue Service (IRS) now seeks to use as an all-purpose hammer to stamp out the use of "non-economic substance transactions" that do not entail the misrepresentation of an asset's value or cost—*i.e.*, valuation misstatements. There is no reason for the Court to adopt that new penalty here, especially since Congress has already amended the statute to address the government's policy concerns.

But this Court also asked the parties to address a threshold issue that dooms the government's challenge from the outset: whether the district court had jurisdiction to determine the applicability of the penalty in this case at all. It did not. For the largely same reasons that the IRS lacked the authority to *impose* that penalty in this partnership-level proceeding, the district court lacked jurisdiction to

determine its applicability in this case. That conclusion follows from the Tax Equity and Fiscal Responsibility Act (or TEFRA), which separates partnership tax issues into one of two camps. One sort of issue may be resolved collectively for all partners, and so is addressed in a partnership-level proceeding. The other sort of issue tends to depend on each partner's individual circumstances, and so must be resolved in partner-by-partner proceedings. The government's theory of imposing the valuation misstatement penalty indisputably depends on the outcome a classic partner-by-partner determination: the partners' tax bases (or "outside basis") in their partnership interests. It is undisputed that the district court lacked jurisdiction to make that outside-basis determination. And the conclusion is no different when it comes to determining the applicability of a penalty based on outside basis.

Accordingly, this Court should dispose of the penalty issue on jurisdictional grounds. But if the Court does reach the merits, it should affirm.

STATEMENT OF THE CASE

I. STATUTORY BACKGROUND

A. Partnership Audits And Judicial Review

1. For federal income tax purposes, partnerships are neither fish nor fowl. Although partnerships can earn income and accrue deductions like individuals, they do not pay federal income tax. 26 U.S.C. § 701; *Guaranty Trust Co. v. Commissioner*, 303 U.S. 493, 496 (1938). Instead, partnerships are tax conduits that allocate the tax consequences of their operations (including "tax items" such as income and deductions) among their partners. The partners in turn report and pay tax on their shares of those tax items. *United*

States v. Basye, 410 U.S. 441, 448 (1973). To facilitate that reporting, partnerships must track their own tax items and report them to the IRS on an information return including the partnership's gross income, deductions, and other items. 26 U.S.C. § 6031(a); *see also* IRS Form 1065 (partnership information return).

2. The jurisdictional issue before the Court turns on the procedures that Congress has enacted for reviewing alleged errors as to partnership information. Before 1982, the IRS lacked a centralized mechanism to correct errors reflected on a partnership return. Instead, the IRS addressed those errors at the partner level by issuing notices of deficiency to the partners whose own returns reflected those errors. The partners then could challenge the asserted deficiency either by filing a petition in the Tax Court, or by paying the deficiency and suing for a refund in district court or the Court of Federal Claims. H.R. Conf. Rep. No. 760, 97th Cong., 2d Sess. 599 (1982). Congress revised those procedures in the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), and established a more unified process for determining partnership-level issues. *See* Pub. L. No. 97-248, § 402, 96 Stat. 648-68 (1982) (codified at 26 U.S.C. §§ 6221 *et seq.*).

The animating principle of TEFRA is that partnerships spawn two different kinds of tax disputes. The first class concerns matters better resolved once and for all partners, rather than seriatim for each partner. Congress called those matters "partnership item[s]," 26 U.S.C. § 6231(a)(3), and created a new proceeding "at the partnership level" to determine them, *id.* § 6221. The other class of disputes concerns "nonpartnership items," *id.* § 6231(a)(4), which are determined at the partner level (as was true before

TEFRA). Nonpartnership items may be entirely disconnected to the partnership (*e.g.*, wages from an unrelated employer), or may be "affected by a partnership item" in some way (*e.g.*, deductions based on an adjustment to a partnership item, *see* 26 C.F.R. § 301.6231(a)(5)-1(a)-(e)). The latter set of nonpartnership items are called "affected items." 26 U.S.C. § 6231(a)(5); *see* U.S. Br. 10 (recognizing that an "affected item" is a "non-partnership item").

TEFRA defines a "partnership item" as "any item required to be taken into account for the partnership's taxable year" for any income tax purpose, but only "to the extent regulations . . . provide that . . . such item is more appropriately determined at the partnership level than at the partner level." 26 U.S.C. § 6231(a)(3); *see* 26 C.F.R. § 301.6231(a)(3)-1(a).[1] Partnership items include "[i]tems of income, gain, loss, deduction, or credit of the partnership" (including their allocation among the partners), as well as "the legal and factual determinations that underlie" the partnership items enumerated by regulation. 26 C.F.R. § 301.6231(a)(3)-1(a)(1)(i), (b). Partners generally must report partnership items on their individual tax return "consistent with the treatment of such partnership item on the partnership return." 26 U.S.C. § 6222(a).

The fundamental partnership tax concepts of "inside basis" and "outside basis" illustrate the difference between partnership items and nonpartnership items. Inside basis refers to the

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[1] Certain regulations cited herein had been promulgated as temporary regulations at the relevant times. But they are substantially identical to current regulations. Unified Partnership Audit Procedures, 66 Fed. Reg. 50,541, 50,543 (Oct. 4, 2001).

partnership's basis in its *own* property. Because a partnership must track its inside basis in partnership assets in order to accurately report depreciation deductions and other tax information, inside basis is a paradigmatic partnership item. *See* 26 C.F.R. § 301.6231(a)(3)-1(c)(2)(iv). By contrast, outside basis refers to a *partner's* basis in a partnership interest, and is generally an affected item—and, therefore, a nonpartnership item—because (except in circumstances not relevant here) a partnership need not track outside basis. *See id.* § 301.6231(a)(5)-1(b).

3. TEFRA segregates partnership items and nonpartnership items throughout the audit process and in providing for judicial review of the IRS's determinations. This arrangement "contemplates that adjustments to partnership items are made in one [audit] proceeding before assessments are made at the individual partner level." *AD Global Fund, LLC v. United States*, 481 F.3d 1351, 1355 (Fed. Cir. 2007). Following that partnership-level audit, the IRS issues a final partnership administrative adjustment (or FPAA) to the partnership. The partners may then challenge any partnership-item adjustments made in the FPAA in district court, or the Tax Court or Court of Federal Claims. 26 U.S.C. § 6226(a). TEFRA provides that courts "shall have jurisdiction [in such a suit] to determine all partnership items of the partnership for the partnership taxable year to which the notice of [FPAA] relates." *Id.* § 6226(f).

Following any judicial proceedings concerning such partnership-level matters, there is an abbreviated process for the IRS to assess and collect the so-called "computational adjustment"—the change in a partner's tax liability due to a partnership item adjustment (such

as an increase in partnership income). *Id.* §§ 6230(a)(1), 6231(a)(6). A partner may seek judicial review of an erroneous computational adjustment in a partner-level case. But to do so, the partner must pay the assessment first, request a refund from the IRS, and then sue for a refund. *Id.* § 6230(c). Those same abbreviated direct-assessment procedures apply to computational adjustments with respect to affected items if no "partner-level determinations" are necessary. 26 C.F.R. § 301.6231(a)(6)-1(a)(2). If affected-item adjustments do require partner-level determinations, then the IRS must give partners a chance to dispute any deficiency in Tax Court without paying the deficiency first. 26 U.S.C. § 6230(a)(1).

Because partnerships are tax conduits and not taxpayers, they are generally not liable for underpaid taxes or penalties. But adjustments to partnership items at the partnership level may make *partners* liable for penalties based on their share of those partnership-item adjustments Under those circumstances, penalties can be affected items, *see, e.g.*, 26 C.F.R. § 301.6231(a)(5)-1(e), and under the pre-1997 TEFRA rules, the IRS could not use the abbreviated direct-assessment procedure for penalties. H.R. Conf. Rep. No. 220, 105th Cong., 1st Sess. 685 (1997).

4. In 1997, Congress modified the TEFRA procedures for certain penalties in the Taxpayer Relief Act (TRA). Congress recognized that the same efficiency benefits from determining all *partnership items* at the partnership level would apply if the applicability of penalties relating to those partnership items were determined at the partnership level as well. Pub. L. No. 105-34, § 1238, 111 Stat. 788, 1026-27 (1997). So Congress modified TEFRA's grant of jurisdiction in

§ 6226(f) to allow courts hearing partnership-level proceedings "to determine . . . the applicability of any penalty, addition to tax, or additional amount which relates to an adjustment to a *partnership item*." 26 U.S.C. § 6226(f) (emphasis added).

In a break from past practice, Congress also provided that certain penalties—specifically, those that relate to adjustments to partnership items—can be immediately assessed. *Id.* § 6230(a)(1). Partners can still assert partner-level defenses, 26 C.F.R. § 301.6221-1(d), but they cannot assert them in ordinary partner-level deficiency proceedings. Instead, partners must file a claim in district court or the Court of Federal Claims "to assert any partner level defenses that may apply or to challenge the amount of the computational adjustment" made after the partnership-level case. 26 U.S.C. § 6230(c)(4). Other than these changes, the TRA did not alter the basic TEFRA rule that nonpartnership items that require partner-level determinations must be determined in a partner-level proceeding and go through the ordinary deficiency procedures discussed above. *Id.* § 6230(a)(2)(A)(i).

B. The "Valuation Misstatement" Penalty

1. The other question before the Court concerns the scope of the valuation misstatement penalty enacted by Congress and now codified in 26 U.S.C. § 6662. The Internal Revenue Code (Code) imposes an array of penalties designed to encourage the proper reporting of tax matters and discourage taxpayers from violating the Code. One set of issues that proved to be especially problematic for the IRS concerned the "valuation of property." H.R. Rep. No. 201, 97th Cong., 1st Sess. 243 (1981) (H.R. Rep. No. 97-201); *see also*

H.R. Conf. Rep. No. 861, 98th Cong., 2d Sess. 985 (1984) (H.R. Conf. Rep. No. 98-861). Property valuation issues arise in many tax contexts, such as in determining the fair market value of property deducted as a charitable contribution, or in determining the cost of property for purposes of calculating one's reportable tax gain or loss (since cost is a controlling factor for tax basis). Such valuation issues were creating havoc for the tax system.

The crux of the problem was the "difficult questions of fact" frequently presented by valuation issues, especially where "unique property is concerned." H.R. Rep. No. 97-201, at 243. These "valuation issues" created an enormous backlog of cases. As of 1981, there were "about 500,000 tax disputes outstanding which involve[d] valuation questions of more than routine significance." *Id.* Often these disputes were "resolved simply by 'dividing the difference' in the values asserted by the [IRS] and those claimed by the taxpayer," creating an incentive for taxpayers to "overvalue certain types of property" and thereby "delay the resolution of valuation issues." *Id.* In light of those problems and the huge backlog of valuation disputes totaling some $2.5 billion, Congress concluded that "a specific penalty is needed to deal with various problems related to valuation of property." *Id.*; *see also* H.R. Conf. Rep. No. 98-861, at 985.

In response, Congress enacted Section 6659 in 1981. Pub. L. No. 97-34, 95 Stat. 172, 341 (1981). The heading of Section 6659 stated, "ADDITION TO TAX IN THE CASE OF VALUATION OVERSTATEMENTS FOR PURPOSES OF THE INCOME TAX," and Section 6659(a) imposed a graduated penalty for "an

underpayment ... attributable to a valuation overstatement." Section 6659(c) further provided:

> [T]here is a valuation overstatement if the value of any property, or the adjusted basis of any property, claimed on any return is 150 percent or more of the amount determined to be the correct amount of such valuation or adjusted basis (as the case may be).

Id. §6659(c), 95 Stat. at 342. Under this provision, "only significant overvaluations [were] penalized," thus "remov[ing] questions involving small differences from the ambit of this new penalty" and helping to clear the backlog of valuation disputes. Staff Joint Comm. on Taxation, 97th Cong., *General Explanation of the Economic Recovery Tax Act of 1981*, at 332 (Joint Comm. Print 1981) (*Blue Book*).

The clause referring to the "adjusted basis of any property" was included in the original version of the penalty and squares with Congress's intention to target *valuation* misstatements. As the government itself recognizes, basis frequently boils down to the purchase price, or cost, of an item—triggering the same set of fact-based valuation issues. *See* U.S. Br. 24, 41, 49; *see also* 26 U.S.C. § 1012(a) ("The basis of property shall be the *cost* of such property, except as otherwise provided.... (emphasis added)).

2. In 1989, Congress—as part of a reorganization of the Code's penalty provisions—repealed the valuation misstatement penalty passed in 1981 and reenacted it as part of the consolidated accuracy-related penalty in Section 6662. Improved Penalty Administration and Compliance Tax (IMPACT) Act, Pub. L. No. 101-239, 103 Stat. 2388, 2399 (1989). The new section imposed a 20% penalty on "the portion of any underpayment

which is attributable to . . . [a]ny substantial valuation overstatement." 26 U.S.C. § 6662(b)(3).

The new penalty further provided:

> [T]here is a substantial valuation overstatement . . . if the value of any property (or the adjusted basis of any property) claimed on any [income tax return] is 200 percent or more of the amount determined to be the correct amount of such valuation or adjusted basis (as the case may be).

26 U.S.C. § 6662(e)(1) (1989). Of note, in the new penalty, Congress moved the reference to "adjusted basis" to a parenthetical clause. *See id.*

The new penalty escalated to 40% for a gross valuation misstatement, *i.e.*, when the overstated value or basis was 400% of the correct amount. *Id.* § 6662(h) (1989). A 1991 Treasury regulation stated that any valuation misstatement would qualify as a gross misstatement if the property had a correct value or basis of zero (which would otherwise render the misstatement percentage mathematically undefined). 26 C.F.R. § 1.6662-5(g). In 2006, the thresholds for both the substantial and gross valuation misstatement penalties were reduced to 150% and 200%, respectively. *See* Pension Protection Act of 2006, Pub L. No. 109-280, § 1219(a)(1)-(2), 120 Stat. 780, 1083.[2]

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[2] Congress substituted the term "valuation misstatement" for "valuation overstatement" in 1990 to account for changes not relevant here. Pub. L. No. 101-508, § 11312(a)-(b), 104 Stat. 1388, 1388-454 to -455 (1990); *see also* H.R. Rep. No. 881, 101st Cong., 2d Sess. 2314 (1990). This brief uses the current term "valuation misstatement," even when referring to earlier versions of the statute that used the term "valuation *overstatement*."

3. For the first two decades after its enactment, the IRS generally focused its application of the valuation misstatement penalty on cases, including tax shelters, involving property misvaluations. *See generally* David J. Shakow, *Valuation Misstatement Penalties Require Valuation Misstatements*, Tax Notes 1283, 1284-85 (June 10, 2013) ("[a]lmost all the cases" involving the penalty in effect during the 1980s "clearly involve issues of valuation, including basis that results from overvaluation") (discussing case law).

The cattle overvaluation tax shelter described in *Persson v. Commissioner*, 58 T.C.M. (CCH) 409 (1989), is typical. There, the taxpayers claimed deductions and credits for a bull that had purportedly been purchased for $400,000. The Tax Court, however, valued the bull at $175,000, and imposed valuation misstatement penalties. *See also, e.g., Boyer v. Commissioner*, 64 T.C.M. (CCH) 1570 (1992) (Section 6659 penalty imposed where cattle had stated purchase price of over $25,000 but experts agreed cows were worth less than $4,000); *Brown v. Commissioner*, 64 T.C.M. (CCH) 20 (1992) (penalizing a tax shelter where prices paid by taxpayers "greatly exceeded the fair market value of the horses and rights they received"), *aff'd without op. sub nom. Konenkamp v. Commissioner*, 14 F.3d 47 (3d Cir. 1993). These schemes also directly impacted "basis," since the taxpayer's basis in the bulls was based on their cost (*i.e.*, their purchase price).

In other words, whether they involved alleged tax shelters (like the cattle cases) or simple factual misrepresentations about the value of property or cost (which could impact basis), the cases in which the IRS invoked the valuation misstatement penalty tended to involve *valuation* misstatements. In the 2000s,

however, the IRS faced a new problem: a wave of tax shelters involving schemes that it determined used transactions lacking in economic substance as a means of artificially inflating basis. In these cases, the IRS's basic complaint is not that taxpayers have inaccurately reported the value or cost of property; it is that, as a purely legal matter, transactions should not be deemed to exist at all for tax purposes. Yet, the IRS nevertheless turned to the valuation misstatement penalty as a way of attacking these schemes, spawning the penalty question presented by this case. *See* Shakow, *supra*, at 1287-88 & n.26 (discussing cases).

4. In 2010, Congress addressed the separate problem presented by taxpayers seeking to inflate basis through transactions deemed to lack economic substance by adding a new "noneconomic substance transaction" penalty tailored to *that* problem. Pub. L. No. 111-152, § 1409(b)(2), 124 Stat. 1029, 1069 (2010) (effective for transactions entered into after March 30, 2010). The new provision applies a 20% penalty "to the portion of any underpayment which is attributable to . . . [a]ny disallowance of claimed tax benefits by reason of a transaction lacking economic substance." 26 U.S.C. § 6662(b)(6). In addition, Congress added a 40% penalty on any portion of an underpayment attributable to "nondisclosed noneconomic substance transactions." *Id.* § 6662(i); *see* I.R.S. Notice 2010-62, 2010-2 C.B. 411 (discussing disclosure requirements).

The "noneconomic substance transaction" penalty is in no way dependent on the presence of a "valuation misstatement." In addition, it was created and codified by Congress as an entirely separate and stand-alone penalty. *See* 26 U.S.C. § 6662(b)(3), (6).

II. FACTUAL AND PROCEDURAL HISTORY

A. Facts Relevant To This Litigation

Respondent Gary Woods was the primary representative in IRS matters (or tax matters partner) for two partnerships that the IRS later determined lacked economic substance. Agreed Findings of Fact ¶¶ 32(c), (d), *Woods v. United States*, (W.D. Tex. Aug. 30, 2010), ECF No. 40 (Agreed Facts). In 1999, both Woods and his business partner Billy "Red" McCombs became investors in those partnerships. *Id.* ¶¶ 1(a), 1(d), 1(e), 2(a). Before investing in the partnerships, Woods consulted extensively with legal and financial experts from nationally recognized firms. *Id.* ¶¶ 13-29.

The investments were made through the following series of transactions:

(1) Through their respective wholly owned limited liability companies (LLCs), Woods and McCombs purchased options on various foreign currencies.

(2) Around the same time, Woods and McCombs (through their respective LLCs) sold comparable foreign currency options.

(3) The LLCs contributed the purchased options (which were assets) and sold options (which were liabilities), as well as a smaller amount of cash, to two Texas general partnerships.

(4) The partnerships used the cash to purchase investment assets (either stock or foreign currency options).

(5) The LLCs transferred their respective interests in those partnerships to a pair of

S corporations jointly owned by Woods and McCombs, causing the partnerships to be treated as liquidated for tax purposes. *See* 26 C.F.R. § 301.7701-2(c)(2).

(6) The S corporations sold the investment assets.

Id. ¶¶ 31-39.

The partnerships and S corporations (which are also treated as conduits for federal income tax purposes) timely filed information returns. *Id.* ¶ 43(f). The two S corporation returns reported the sales price, basis, and resulting losses from the sale of the investment assets. JA 200, 215. Because the basis of an asset received upon the liquidation of a partnership is equal to the partner's basis in the partnership interest (or "outside basis"), 26 U.S.C. § 732(b), the S corporations reported the basis of those assets as equal to the value of the purchased options originally contributed to the partnerships by the LLCs, *id.* § 722. In doing so, the parties to the transaction relied on professional advice that the liability associated with the sold options was too contingent to reduce outside basis. Trial Tr. 88:1-90:15 (W.D. Tex. Sept. 15, 2010) (Morning Sess.).

After conducting a partnership-level audit, the IRS issued FPAAs to Woods (as tax matters partner for the partnerships) and McCombs denying that the transactions involving the partnerships had any legal effect. In particular, the FPAAs (1) denied "the existence of" the partnerships, and (2) asserted that the partnership transactions "had no business purpose other than tax avoidance, lacked economic substance, and in fact and substance, constitute[] an economic sham for federal income tax purposes." JA 92, 146.

The FPAAs also imposed accuracy-related penalties, including 20% penalties for underpayments attributable to negligence and substantial understatements of income, and a 40% penalty for gross valuation misstatements. JA 96-97, 150-51.

B. Decisions Below

1. In 2005, Woods—as tax matters partner of both partnerships—brought this action on behalf of the partnerships in district court seeking review of the FPAAs, alleging that the tax consequences of the transactions described above were correctly reported and that, in any event, penalties were inappropriate. The petition for review asserted jurisdiction under TEFRA (26 U.S.C. § 6226(a)) and 28 U.S.C. § 1346(a)(1). JA 52. The district court found that the transactions lacked economic substance and held that the losses reported by the S corporations (and passed through to Woods and McCombs) "should be disregarded for tax purposes." Pet. App. 21a.

After additional briefing, the district court determined in light of the economic substance holding that the valuation misstatement penalty did not apply. The district court relied on *Heasley v. Commisioner*, in which the Fifth Circuit held that, "[w]henever the I.R.S. totally disallows a deduction or credit, the I.R.S. may not penalize the taxpayer for a valuation overstatement included in that deduction or credit." 902 F.2d 380, 383 (5th Cir. 1990). Following *Heasley*, the district court held that the underpayment at issue here "is not attributable to a valuation overstatement; it is attributable to claiming an improper deduction." Pet. App. 6a. The district court upheld the other penalties imposed in the FPAAs for negligence and substantial understatements. *Id.* at 7a-12a.

2. The United States appealed the denial of the 40% penalty for a gross valuation misstatement. The government recognized that Woods accurately reported the basis of each purchased option underlying the transactions at issue, *i.e.*, that the actual cost of each purchased option (U.S. CA5 Br. 11-12) was equal to the reported basis for each purchased option (JA 169, 186). But the government argued that the valuation misstatement penalty nevertheless applies because the transactions that were deemed to lack economic substance had the effect of improperly inflating basis. The Fifth Circuit affirmed in an unpublished per curiam opinion citing *Heasley* and *Todd v. Commissioner*, 862 F.2d 540, 543 (5th Cir. 1988), which held that the valuation misstatement penalty does not apply where deductions are deemed "inappropriate altogether." *See* Pet. App. 2a.

Neither of the courts below—nor the parties—addressed or questioned the courts' jurisdiction under TEFRA to determine penalties.

SUMMARY OF ARGUMENT

I. The district court lacked jurisdiction to decide whether the valuation misstatement penalty applies in this partnership-level proceeding—for essentially the same reasons that the IRS lacked the authority to impose that penalty in the FPAAs to begin with. TEFRA reorganized the partnership tax world to pair partnership-level issues with partnership-level proceedings for both audit and judicial review, and vice versa for partner-level issues and proceedings. The linchpin of the government's theory that the valuation misstatement penalty applies in this case is that the partners overstated their outside basis. But, as the

government readily admits, that outside basis is not a *partnership* item under TEFRA. It follows that outside basis cannot be determined in a partnership-level proceeding. And because the district court lacked jurisdiction to determine the partners' outside basis, it lacked jurisdiction to determine penalties that depend on that forbidden outside-basis determination.

The grant of jurisdiction to determine—in a partnership-level proceeding—"the applicability of any penalty ... which relates to an adjustment to a *partnership item*" (26 U.S.C. § 6226(f) (emphasis added)) does not change that outcome. The penalty at issue in this case undeniably relates to the adjustment of a nonpartnership item—outside basis—not to a partnership item. It is true that the outside-basis determination, in turn, relates to the adjustment of a partnership item—*i.e.*, the determination whether a partnership transaction should be "shammed" for lack of economic substance. But if it were enough for jurisdictional purposes that a penalty relate to a nonpartnership-item adjustment that, in turn, relates to a partnership-item adjustment, then the limitation to penalties "which relate[] to an adjustment to *partnership items*" would be rendered essentially meaningless and could readily be circumvented.

II. On the merits, the court of appeals correctly concluded that the valuation misstatement penalty does not apply in the situation presented here. The text, history, and structure of the penalty confirm that it was intended to cover "valuation misstatements"—*i.e.*, factual misrepresentations concerning an asset's worth or cost. That is perfectly consistent with the penalty's parenthetical reference to "adjusted basis" because—as the government admits (at 24)—it is

"commonplace" for "basis errors" to arise "from the taxpayers' factual misrepresentation about a particular purchase price or value." Accurately reporting a transaction that is later deemed not to exist at all as a legal matter under the economic substance doctrine does not present a "valuation misstatement." And Congress confirmed as much when it enacted a new, and separate, "non-economic substance transaction" to address that different situation in 2010. The all-encompassing "basis-overstatement penalty" that the government erroneously says Congress adopted in 1981 would render the 2010 "non-economic substance transaction penalty" essentially superfluous.

The valuation misstatement penalty is also inapplicable in this case because the tax underpayment is not "attributable to" any valuation misstatement (26 U.S.C. § 6662(b)(3)), as the Fifth Circuit held below. To be "attributable to" a valuation misstatement, an underpayment must *result from* that misstatement. But when the IRS "shams" a transaction on legal grounds, and thus disallows all tax benefits following from that transaction because it is deemed not to exist, the underpayment results from the fact that the resulting tax benefits have been wiped out along with the transaction (and not from any valuation misstatement in connection with the underlying transaction that has been "shammed"). Any valuation misstatement underlying the "shammed" transaction is completely irrelevant to the underpayment, because the whole point of "shamming" the transaction is to deem it non-existent for tax purposes.

If there were any doubt about the applicability of the valuation misstatement penalty to the situation presented by this case, the canon that tax laws—and

tax penalties—must be strictly construed would require resolving that doubt in favor of the taxpayers. Whatever else is true, it cannot be said that Congress plainly intended the penalty to apply when the underpayment results from a legal determination that a transaction lacks economic substance. And while the government frequently enjoys the benefit of the doubt under administrative deference principles, the citizens enjoy that benefit when, as here, the government is training its fearsome tax power on them.

III. The government's policy plea to adopt its proposed "basis-overstatement penalty" not only misconceives the appropriate function of this Court in a statutory interpretation case, but overlooks that Congress has already answered that plea. In 2010, Congress amended the Code to add a new, stand-alone "non-economic substance transaction penalty" that directly addresses the situation here. The fact that Congress declined to make that penalty retroactive provides no reason for this Court to rewrite the valuation misstatement penalty in a way that would render Congress's recent action largely superfluous. The IRS has all the tools its needs today to address the problems that it complains about here. This Court need not subvert the *valuation* misstatement penalty to achieve the IRS's policy objectives.

ARGUMENT

The United States asks this Court to decide whether the valuation misstatement penalty applies when a transaction is disregarded for legal purposes under the economic substance doctrine. As explained in Part II below, the court of appeals correctly held that the penalty does not apply in that situation,

though there is an even more fundamental reason for why that is so than the one given by the Fifth Circuit: there simply is no *valuation* misstatement in that context. In granting certiorari, this Court instructed the parties to also address whether the district court had jurisdiction to consider the applicability of this penalty in this partnership-level proceeding. As explained in Part I below, having considered that issue in light of this Court's direction, respondents believe that the answer is no. Accordingly, although the Fifth Circuit correctly held that the penalty does not apply, this case should be disposed of on jurisdictional grounds and the applicability of the penalty will have to be reserved for a future partner-level case.

I. THE DISTRICT COURT LACKED JURISDICTION TO CONSIDER THE VALUATION MISSTATEMENT PENALTY

This case was brought as a challenge to FPAAs issued after a partnership-level audit, which assert that the valuation misstatement penalty applies based on a conclusion that the partners' misstated their outside basis in partnership items. JA 94-97, 148-51. The jurisdictional question raised by this Court boils down to whether this partnership-level proceeding is the right way to determine the applicability of this penalty, or whether it should be determined in a later partner-level proceeding. TEFRA strictly, but sensibly, pairs partnership-level issues with partnership-level proceedings on audit and judicial review—and vice versa for partner-level issues. As explained below, however, there is a fundamental mismatch between this partnership-level proceeding and the partner-level issue at the heart of the penalty at issue. The Court

accordingly must conclude that the district court lacked jurisdiction to determine that penalty.

A. The Valuation Misstatement Penalty Hinges On A Partner-Level Determination That TEFRA Explicitly Makes Off-Limits In A Partnership-Level Proceeding

The cornerstone of the government's position that the valuation misstatement penalty applies in this case is that respondents overreported their outside basis in a partnership—because the IRS legally deemed that partnership to be a sham. In order to determine whether outside basis was overstated, the district court would necessarily have to determine what outside basis actually was—which the government itself concedes is a *partner*-level question. U.S. Br. 33. By its terms, TEFRA does not grant a district court jurisdiction to make that partner-level determination in a partnership-level proceeding like this.

1. The government's theory for applying the asserted penalty proceeds in three steps: (1) the partnership transactions lacked economic substance and constituted a sham; (2) a partner's outside basis in a sham partnership is zero; and (3) claiming any outside basis greater than zero results in an underpayment of tax. U.S. Br. 41. The government candidly admits that "any overstatement penalty ultimately imposed on the taxpayers in this case will be premised on misstatements of outside basis." *Id.* at 33.

But to reach that conclusion, there must be jurisdiction to determine that the partners actually misrepresented their outside basis. That premise cannot be assumed—the practice of "'assuming' jurisdiction for the purpose of deciding the merits . . .

offends fundamental principles of separation of powers." *Steel Co. v. Citizens for a Better Env't*, 523 U.S. 83, 94 (1998). This Court has accordingly quashed the "'doctrine of hypothetical jurisdiction,'" *id.* (citation omitted), and reaffirmed that "[w]ithout jurisdiction the court cannot proceed at all in any cause,'" *id.* (quoting *Ex parte McCardle*, 74 U.S. (7 Wall.) 506, 514 (1869)). That is particularly true here, where Congress has crafted a jurisdictional regime that carefully assigns the responsibility for certain questions only to certain proceedings. Jurisdiction to decide that the partners misstated outside basis is essential here.

2. The district court lacked jurisdiction to decide that question—just as the IRS lacked authority to impose the penalty in a partnership-level audit in the first place. As discussed, under TEFRA's division of responsibility between partner-level and partnership-level proceedings, the universe of tax items is divided between partnership items (including their allocation among the partners and penalties relating to adjustments to those partnership items) and nonpartnership items (including so-called "affected items" that are merely "affected by a partnership item"). 26 U.S.C. § 6231(a)(4)-(5). Nonpartnership items (other than penalties relating to adjustments to partnership items) must be determined in partner-level proceedings, not in the partnership-level affair.

As the government has conceded, outside basis is a nonpartnership item under this scheme. *See* U.S. Br. 32 & n.7; *see also* U.S. Br. 32-33 & n.15, *Logan Trust v. Commissioner*, No. 12-1148 (D.C. Cir. Oct. 25, 2012) ("We agree that outside basis is an affected item, not a partnership item . . . ."). To qualify as a partnership item, an item must be (1) "required to be taken into

account for the partnership's taxable year," and (2) "more appropriately determined at the partnership level than at the partner level," as determined by regulation. 26 U.S.C. § 6231(a)(3). Outside basis is neither. As relevant here, "outside basis is not an 'item required to be taken into account for the partnership's taxable year.'" U.S. Br. 33 n.15, *Logan Trust v. Commissioner*, No. 12-1148 (D.C. Cir.); *see also* U.S. Br. 32 & n.7. And Treasury regulations provide that "[t]he basis of a partner's partnership interest [*i.e.*, outside basis] is an affected item to the extent it is not a partnership item." 26 C.F.R. § 301.6231(a)(5)-1(b).

Since outside basis flunks both of the "partnership item" tests, outside-basis adjustments could only be determined in a partner-level proceeding *after* the partnership-level proceeding has concluded. *See* 26 U.S.C. § 6230(a)(2)(A)(i); Chief Counsel Notice 2009-11 at 3 (Mar. 11, 2009) ("The partner's basis in the partnership interest or the distributed asset and the resulting loss is an affected item that requires further determinations at the partner level . . . ."). That is true not only for the district court's authority to determine the applicability of the penalty in this proceeding, but for the IRS's authority to impose it in the FPAAs at issue, which are based on the partnership-level audit.

3. The government argues that the district court had jurisdiction to determine that a penalty applies based on alleged misstatements of outside basis *before* any court has determined that such basis was actually misrepresented. That argument has an Alice-in-Wonderland feel to it. *See Tigers Eye Trading, LLC v. Commissioner*, 138 T.C. 67, 189 (2012) (Holmes, J., dissenting) (observing that "it's usually only in Wonderland, or in the more unpleasant judicial

systems around the world, that 'penalty first—verdict afterwards' is the rule") (quoting Lewis Carroll, *Alice's Adventures in Wonderland* 109 (Oxford Univ. Press 2009)). And it has been rejected by the District of Columbia and Federal Circuits. As Judge Sentelle explained, "since the [court] lacked jurisdiction to determine outside basis, it also lacks jurisdiction to determine that penalties apply with respect to outside basis." *Petaluma FX Partners LLC v. Commissioner*, 591 F.3d 649, 655 (D.C. Cir. 2010); *accord Jade Trading, LLC v. United States*, 598 F.3d 1372, 1379-80 (Fed. Cir. 2010). That logic is unassailable.

The government has argued in other cases that even though outside basis is not a partnership item, the conclusion that the outside basis of a *sham* partnership is zero is so "obvious" as to eliminate the need for a partner-level determination of outside basis. *See, e.g.*, U.S. Br. 52, *Petaluma*, No. 08-1356 (D.C. Cir.). But the District of Columbia and Federal Circuits have correctly rejected that argument as well: "The fact that a determination seems obvious or easy does not expand the court's jurisdiction beyond what the statute provides. In other words, it does not matter how low the fruit hangs when one is forbidden to pick it." *Petaluma*, 591 F.3d at 655; *accord Jade Trading*, 598 F.3d at 1380. Under TEFRA, the partner-level determination of outside basis must be made at the partner level, no matter how obvious the government claims that determination will be.

B. The Court Should Reject The Government's Attempt To Engage In An End-Run Around TEFRA's Jurisdictional Limits

Because it is clear that the outside-basis determination necessary to the imposition of the penalty must be made in a partner-level proceeding, the government focuses its jurisdictional argument on the fact that the TRA created a limited exception that allows the IRS and courts to determine—in a partnership-level proceeding—"the applicability of . . . any penalty . . . which relates to an adjustment to a partnership item." 26 U.S.C. §§ 6221, 6226(f). But that provision cannot bear the weight that the government places on it in trying to create jurisdiction here.

1. The parties agree about the driving force behind the IRS's case: "Any overstatement penalty assessed in this case will be assessed because the partners claimed a basis higher than zero in those assets." U.S. Br. 32. The same was true in the substantially identical cases considered by the District of Columbia and Federal Circuits, where the valuation misstatement penalty "was imposed on the underpayment of income tax due to the [asserted] gross valuation misstatement of the partners' outside basis in the partnership." *Jade Trading*, 598 F.3d at 1380; *accord Petaluma*, 591 F.3d at 655. Under a straightforward application of Section 6226(f), the valuation misstatement penalty "relates to" such an adjustment to outside basis.

But as the District of Columbia and Federal Circuits concluded, that is not enough to establish jurisdiction in a partnership-level proceeding. Because "outside basis is an affected item, not a partnership item," the asserted penalty "relates to an adjustment of an affected item, not a partnership item." *Jade*

Trading, 598 F.3d at 1380. But Section 6226(f) creates penalty jurisdiction only when the penalty relates to a *partnership* item—not an affected item, which is, by definition, a *nonpartnership* item. *See Petaluma*, 591 F.3d at 655 (finding no "jurisdiction to determine that penalties apply with respect to outside basis because those penalties do not relate to an adjustment to a *partnership* item.") (emphasis added); U.S. Br. 9-10.

In order to avoid that straightforward application of Section 6226(f), the government asks the Court to look beyond the outside-basis adjustment on which its theory for imposing the penalty rests to see if any partnership item "'has a connection with or reference to' th[at] adjustment." *Id.* at 31-32 (citation omitted). In other words, according to the government, the adjusted item that triggers the penalty does not have to be a partnership item, so long as a partnership item is connected to that adjusted item *in some way*. Here, the government argues that that "connection" exists between the district court's sham determination and outside basis, and so concludes that the valuation misstatement penalty "relate[s] to" the sham determination (which is an adjustment to a partnership item). *Id.* at 32. Translation: "Ignore the outside basis and just look at the sham determination," even though the whole point of making the sham determination is to upset the taxpayers' outside basis.

The government made basically the same "pay no attention to that man behind the curtain" argument before the District of Columbia Circuit in *Petaluma*. *See* U.S. Br. 60, *Petaluma*, No. 08-1356 (D.C. Cir.) (Because "the partnership was a sham, the claimed contributions of property to the purported partnership necessarily were overstated. Thus, the penalties do

'relate' to partnership items . . . ."); *see also id.* at 57-58 ("[T]he words 'relates to' in §§ 6221 and 6226(f) . . . include penalties that indirectly relate to partnership items."). But that court recognized the argument for what it was—an end-around attempt to circumvent the jurisdictional limits of Section 6226(f). A penalty based on outside basis requires a partner-level determination whether or not the penalty has a connection to a partnership item. But that partner-level inquiry is forbidden at the partnership-level. *See Petaluma*, 591 F.3d at 655; *see also Jade Trading*, 598 F.3d at 1380.

2. Even if such an expansive reading of "relates to" would be appropriate in other contexts, the government itself recognizes here that "the language of Section 6226(f)" must be read in light of its "larger statutory context." U.S. Br. 34-35. In that larger context, the government's interpretation falls flat. Section 6226(f) specifically authorizes jurisdiction to determine the applicability of penalties that "relate[] to an adjustment to a partnership item." For example, the district court could have considered the valuation misstatement penalty if the *partnership itself* had donated a flea market painting to charity but reported the valuation of a Renoir. The charitable deduction would be a partnership item, and the valuation misstatement penalty relating to *that* partnership item adjustment could be adjudicated at the partnership level. 26 C.F.R. § 301.6231(a)(3)-1(a)(1)(i).

By contrast, Section 6226(f) does not confer jurisdiction over penalties that relate to adjustments to *affected items*—which, indisputably, are not partnership items. Given the specific jurisdictional grant over penalties relating to partnership-item adjustments, Congress sensibly left jurisdiction over

penalties relating to nonpartnership-item adjustments where it was before: at the partner level. *See, e.g.*, 26 C.F.R. § 301.6221-1(c) ("Assessment of any penalty . . . that relates to an adjustment to a partnership item shall be made based on partnership-level determinations."). The government's interpretation of "relates to" would rewrite Section 6226(f) to create precisely the jurisdiction that Congress withheld.

That would not be mere tinkering with the statute. To the contrary, it would upset TEFRA's jurisdictional scheme. If the government wishes to impose a penalty based on an affected-item adjustment (as it does here), it will always be able to find a correlative adjustment to a partnership item. That follows from the statutory definition of "affected item," which includes "any item *to the extent such item is affected by a partnership item.*" 26 U.S.C. § 6231(a)(5) (emphasis added). Here, to reiterate the point, outside basis is an affected item because it is affected by the sham determination (a partnership item). So a penalty that directly "relates to" an affected item adjustment will always indirectly "relate[] to" a partnership item adjustment. *See* U.S. Br. 33. If that indirect relationship satisfies the requirement of Section 6226(f), then Congress's omission of penalty jurisdiction over adjustments to nonpartnership items will be effectively undone.

TEFRA separately defines "partnership item" (Section 6231(a)(3)), "nonpartnership item" (Section 6231(a)(4)), and "affected item" (Section 6231(a)(5)), and it is undisputed that an "affected item" is a nonpartnership item (U.S. Br. 10). Accordingly, Congress's use of "partnership item" in Section 6226(f) is significant, and should be given effect. Congress granted jurisdiction to determine the applicability of a

penalty that "relates to an adjustment to a *partnership item*." It did not confer jurisdiction to determine the applicability of a penalty that "relates to an adjustment to an *affected item*." And it did not confer jurisdiction to determine the applicability of a penalty that "relates to an adjustment to a nonpartnership item (like outside basis) that, in turn, relates to a partnership item" (which is another way of saying an affected item). The government's interpretation would render Congress's use of "partnership item" largely meaningless.[3]

3. The government attempts to reframe its argument by claiming that the valuation misstatement penalty relates to the determination that the *contributions to* and *distributions from* the partnership were shams (rather than that the partnership transaction itself was a sham). *See* U.S. Br. 31, 33-34. But here again, the government runs into the problem that it is hard to "think about a thing inextricably attached to something else without thinking of the thing which it is attached to." Thomas Reed Powell, *quoted in* Thurman W. Arnold, *The Symbols of Government* 101 (1935). However the issue is framed, "any overstatement penalty ultimately imposed on the taxpayers in this case will be premised on misstatements of outside basis" (U.S. Br. 33)—a

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[3] The government argues that its interpretation does not "render the 'relates to' limitation superfluous" because "a penalty might be imposed . . . for misstating affected items if liability for such penalties does not turn on adjustments to partnership items." U.S. Br. 34. That is a head scratcher. If an item does not turn on adjustments to a "partnership item," it is not an "affected item." 26 U.S.C. § 6231(a)(5). And, in any event, whether the government's interpretation renders "relates to" superfluous or not, the government is urging the Court to rewrite the statute.

premise that was beyond the jurisdiction of the district court to determine in this partnership-level case.

To be clear, the district court undeniably had jurisdiction over other aspects of this case, such as respondents' challenge to the IRS's decision to sham the partnership transactions (a partnership item). The only question here is the court's jurisdiction over penalties, and that jurisdiction was lacking.

C. For Essentially The Same Reasons That The District Court Lacked Jurisdiction, The IRS Lacked Authority To Impose The Penalty In The FPAAs To Begin With

For largely the same reasons that the district court lacked jurisdiction to determine the applicability of the valuation misstatement penalty in this partnership-level proceeding, the IRS lacked the authority to impose that penalty at all in the FPAAs that were the result of the partnership-level audit (JA 95-97, 149-51). Just as TEFRA limits the jurisdiction of a district court to partnership-level matters in a partnership-level proceeding (in § 6226(f)), the statute bifurcates and limits the authority of the IRS in the same fashion (in § 6221(a)). Which is to say, partnership-level proceedings may not be used to make partner-level determinations—and may not be used to determine penalties that depend on future partner-level determinations. *See supra* at 21-24. Accordingly, if the IRS wishes to penalize partners for their treatment of affected items (like outside basis), the government must use the partner-level audit and review procedures specified by TEFRA. *Supra* at 5-6.

Respondents here were left with essentially no choice but to challenge the IRS's determination of penalties in this case because the penalties were

(erroneously) imposed in the FPAAs. Indeed, if respondents had not challenged the penalties, the government likely would have argued that respondents waived the right to challenge their imposition against the partners individually. *Cf.* U.S. Br. 10 (citing 26 U.S.C. § 6230(c)(4)). To prevent putting taxpayers between the same rock and a hard place in the future, the Court should make clear that the IRS lacks authority under TEFRA to impose partner-level penalties (or any penalties, like the one at issue here, that depend on a partner-level determination) in an FPAA issued as the result of a partnership-level audit. Under TEFRA, such penalties may only be imposed by the IRS, if at all, in a partner-level proceeding in which all necessary determinations, such as outside basis for the penalty at issue here, are made, and in which partners may challenge those penalties.[4]

II. THE VALUATION MISSTATEMENT PENALTY DOES NOT APPLY

On the merits, the courts of appeals properly held that the valuation misstatement penalty does not apply where, as here, a transaction is accurately reported, but is simply deemed not to exist as a legal matter under the economic substance doctrine. The Fifth

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[4] For the same reasons that the district court lacked jurisdiction to determine the valuation misstatement penalty, it lacked jurisdiction to consider the other accuracy-related penalties. Pet. App. 7a-14a. Thus, if this Court vacates the district court's penalty judgment, it should do so in its entirety. *See Petaluma*, 591 F.3d at 655-56; *Jade Trading*, 598 F.3d at 1380. In addition, the Court should remand the case to the district court so that it may consider whether any other action is necessary or appropriate in light of this Court's decision, including return of any jurisdictional deposit (26 U.S.C. § 6226(e)(1)) tied to penalties.

Circuit has reasoned that the valuation misstatement penalty is inapplicable in that situation on the ground that, where a deduction or loss is disallowed altogether, an underpayment is not "attributable to" any valuation misstatement, since any valuation misstatement "play[s] no part in calculating the tax ... actually owed." *Todd*, 862 F.2d at 541-42. But this Court need not even reach that argument, because there is an even more fundamental reason that the penalty is inapplicable: there was no "valuation misstatement" to begin with. Without a valuation misstatement, the *valuation misstatement* penalty cannot apply.

A. The "Valuation Misstatement" Penalty Is Not Triggered By Transactions That Are Accurately Reported But Deemed Not To Exist Based On A Legal Conclusion That They Lack Economic Substance

Fundamentally, the penalty question in this case concerns the problem that Congress meant to address when it enacted the "valuation misstatement" penalty. To its credit, the government recognizes the crux of the issue: Consistent with the valuation problems that Congress set out to address when it enacted the penalty, the "run-of-the-mill case" in which the penalty has been applied is where "a taxpayer simply overstates the value or purchase price of an asset." U.S. Br. 41; *see id.* at 49 (the "more prosaic" situation in which the penalty has been applied is "where a taxpayer overstates his basis in sold property by misrepresenting the relevant facts"). Yet, as the government concedes (*id.* at 41), here the alleged overstatements "arise not from the taxpayers' factual misrepresentation about a particular purchase price or

value," but rather because of a legal determination that the property should be deemed not to exist under the economic substance doctrine. *Id.* at 24.

The government argues (at 41) that this distinction is "immaterial," but the text, history, and structure of the statute point to the opposite conclusion. And Congress underscored that conclusion when, in 2010, it adopted a new, "non-economic substance transaction" penalty explicitly addressing the issue here. What the government asks the Court to do here is not to enforce the valuation misstatement penalty, but rather to *create* a "basis-overstatement penalty"—a term that the government mints in its brief and uses no fewer than 28 times throughout its brief—that does not depend on the existence of a *valuation* error at all. As explained below, the standard tools of statutory construction compel the conclusion that Congress did not enact the government's "basis-overstatement penalty," and that the valuation misstatement penalty that it *did* adopt is inapplicable here.[5]

1. The Text And History Of § 6662 Make Clear That The "Valuation Misstatement" Penalty Does Not Cover The Different Situation Here

a. This Court of course starts with the text of the provision, and here the most important textual clue is Congress's use of "valuation." The ordinary meaning of "valuation" is a fact-based assessment of the monetary

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[5] Because of the "clearly established" (Pet. App. 6a) circuit precedent holding that the penalty does not apply for the reasons discussed in Part II.B, *supra*, there was no need for respondents to make this threshold argument in the courts below in justifying their over-arching position that the penalty does not apply.

worth (or value) of something.[6] Consistent with that meaning, Section 6662(e)(1)(A) explains that there is a valuation misstatement with respect to value when "the value of any property (or adjusted basis of any property) claimed on any return of tax imposed by chapter 1 is 150 percent or more of the amount determined to be the correct amount of such valuation." 26 U.S.C. § 6662(e)(1)(A). The reference to "correct amount" reinforces that Congress had the ordinary meaning of "valuation" in mind. Moreover, Congress did not just use the word "valuation" in explaining how the penalty operates, it called the penalty a "valuation misstatement" penalty and used that phrase in the headings of Sections 6662(e) and -(h). Congress's use of "valuation misstatement[s]" in the penalty's headings underscores that its reference to "valuation" is significant. *See Florida Dep't of Revenue v. Piccadilly Cafeterias, Inc.*, 554 U.S. 33, 47 (2008).

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[6] Dictionaries published around the time of the penalty's enactment (1981) agree on the ordinary meaning of "valuation" and confirm that it is inherently fact-based. *See, e.g., Webster's Third New Int'l Dictionary* 2530 (1981) ("1 : the act or process of valuing or of estimating value or worth: as **a** : the act or process of setting or determining the price of something : APPRAISAL . . . 2 : the value or price set upon something as its estimated or determined market value"); *Webster's New Collegiate Dictionary* 1283 (1981) ("1: the act or process of valuing; *specif*: appraisal of property 2: the estimate or determined market value of a thing"); *Random House Dictionary of the English Language* 2103 (2d ed. 1987) ("1. the act of estimating or setting the value of something; appraisal. 2. An estimated value or worth."); *American Heritage Dictionary of the English Language* (1981) ("1. The act or process of assessing the value or price of something: an appraisal. 2. The assessed value or price of something.").

As the plain meaning of "valuation" reflects (*see* note 6, *supra*), valuation is inherently a factual—rather than legal—concept. That meaning is confirmed by the practice of the Tax Court, whose valuation docket spurred the adoption of the valuation misstatement penalty in the first place. The Tax Court has a longstanding practice of treating valuation issues as matters of *fact*, rather than questions of law. *See, e.g.*, *Newcomb v. Commissioner*, 23 T.C. 954, 962 (1955) ("[V]aluation . . . presents a question of fact peculiar to each individual case."); *Estate of Mellinger v. Commissioner*, 112 T.C. 26, 38 (1999) ("Valuation is a question of fact, so the tax court must weigh all relevant evidence to draw the appropriate inferences."). Congress is presumed to be aware of that pratice when it enacted the penalty. *See Goodyear Atomic Corp. v. Miller*, 486 U.S. 174, 184-85 (1988).

b. The legislative history overwhelmingly confirms that the valuation misstatement penalty was intended to address situations presenting "valuation" issues. Congress created the penalty based on the judgment that "a specific penalty is needed to deal with various problems related to valuation of property." H.R. Rep. 97-201, at 243. Specifically, Congress was concerned with "difficult questions of fact" that property valuation issues presented, "especially where unique property is concerned," which had created an enormous backlog of tax disputes. *Id.* Thus, in 1981, Congress enacted a valuation overstatement penalty to apply "if a taxpayer makes a large error in placing *too high a value on property* which results in an understatement of tax." 128 Cong. Rec. 8965 (1982) (statement of Rep. Roskenkowski) (emphasis added).

In 1989, when Congress reenacted the valuation misstatement penalty, Congress yet again reaffirmed its understanding that valuation is a fact-based inquiry—affecting such areas as "charitable contributions of property, depreciation or amortization of acquired assets, the basis of inherited property and so forth"—and that valuation "is often, in fact, usually a matter of widely varying opinions even among *experts*," and not a legal determination to be made by jurists. *Review of the Civil Penalty Provisions Contained in the Internal Revenue Code: Hearings on H.R. 2528 Before the Subcomm. on Oversight of the H. Comm. on Ways and Means*, 101st Cong. 114 (1989) (emphasis added). Indeed, Congress observed that "[d]ifferences in estimates of value by equally qualified appraisers often differ by more than 50 percent" based on "failure to apply sound valuation principles or reliance on unqualified appraisers." *Id.* at 121.

Although not all members of this Court attach significance to such legislative history, for those who do this is compelling additional evidence that Congress meant the penalty to address misstatements about *valuation*—an inherently factual concept concerning the worth or cost of property. *See, e.g., Kirtsaeng v. John Wiley & Sons, Inc.*, 133 S. Ct. 1351, 1361 (2013); *Hertz Corp. v. Friend*, 559 U.S. 77, 95 (2010); *Samantar v. Yousuf*, 130 S. Ct. 2278, 2289 n.12 (2010).

2. Congress Did Not Adopt The Open-Ended "Basis-Overstatement Penalty" Conceived By The Government

Relying on Congress's inclusion of the clause "(or adjusted basis of any property)," the government asserts that Congress actually adopted a "basis-overstatement penalty." *E.g.*, U.S. Br. 2, 21, 23. To be

sure, the "valuation misstatement" penalty that Congress enacted can apply to misstatements of basis too, but only when basis is incorrectly reported due to a factual misrepresentation of property's worth or cost—that is, a *valuation* misstatement. The government asks this Court to take the reference to "adjusted basis" and conclude that Congress enacted an entirely different penalty, which could be invoked any time a taxpayer's basis has been overstated—regardless of whether there is any valuation misstatement at all. The Court should reject that interpretation.

a. To begin with, Congress's reference to "adjusted basis" is perfectly consistent with its enactment of a *valuation* misstatement penalty—and by no means compels the conclusion that Congress meant to adopt an omnibus "basis-overstatement penalty." Indeed, the government admits that the "run-of-the-mill case" in which the penalty applies is "where a taxpayer overstates his basis in sold property *by misrepresenting the relevant facts*." U.S. Br. 41, 49 (emphasis added); *see id.* at 24 ("more commonplace basis errors" arise "from the taxpayers' factual misrepresentation about a particular purchase price or value"). And, by definition, basis often turns on the purchase price, or cost, of an item—triggering a classic valuation issues. 26 U.S.C. § 1012(a). The reference to "adjusted basis" therefore hardly compels the interpretation advanced by the government.

b. Moreover, as is true of all "statutory language," Congress's reference to "adjusted basis" here "must be read in context and . . . 'gathers meaning from the words around it.'" *Jones v. United States*, 373 U.S. 373, 389 (1999) (quoting *Jarecki v. G.D. Searle & Co.*, 367 U. S. 303, 307 (1961)); *accord Whitman v. American*

Trucking Ass'ns, Inc., 531 U.S. 457, 466 (2001). In context, the reference to "adjusted basis" simply clarifies that factually inaccurate assertions of "adjusted basis" (which arise from misrepresentations about price or cost) count as valuation misstatements.

That conclusion is reinforced by the grammatical structure of § 6662(e)(1)(A), which refers to "adjusted basis" in a parenthetical clause: "the value of any property (or the adjusted basis of any property)." 26 U.S.C. § 6662(e)(1)(A). In the 1981 version of the penalty, the reference to "adjusted basis" was including in a clause set off by commas. When Congress repealed and reenacted the penalty in 1989, it replaced the commas with parentheses. *Supra* at 8-10. Those parentheses—like all punctuation used by Congress—must be given effect in construing the statute. *See* Antonin Scalia & Bryan A. Garner, *Reading Law: The Interpretation of Legal Texts* 161 (2012) ("No intelligent construction of a text can ignore its punctuation.").

This parenthetical construction signals that the item inside the parentheses is meant to illustrate or explain what is outside the parentheses—not *change* it. *See, e.g., Novacor Chems., Inc. v. United States*, 171 F.3d 1376, 1381 (Fed. Cir. 1999) ("the parenthetical is merely an illustrative example"). In particular, courts have recognized that parenthetical phrases such as the one used in Section 6662(e)(1)(A) do not have "broad and independent meaning." *Disabled in Action of Pa. v. Southeastern Pa. Transp. Auth.*, 539 F.3d 199, 212 (3d Cir. 2008). Instead, such parenthetical clauses ordinarily are "related to, or dependent upon" their non-parenthetical antecedents for meaning. *Id.* This is not news to the Solicitor General. *See, e.g.*, U.S. Br. 21,

Logan v. United States, No. 06-6911 (2007) (arguing that the conclusion that Congress intended certain language to clarify rather than *change* the meaning of a provision is "strengthened by Congress's use of a parenthetical phrase (a parenthetical, after all, being where one expects clarifying language).").

The fact that Congress replaced the commas that surrounded "or the adjusted basis of any property" in § 6659 (enacted in 1981) with parentheses in § 6662 only increases the significance of the parentheses. *See, e.g.*, *Peters v. Ashcroft*, 383 F.3d 302, 309 (5th Cir. 2004) ("Congress in fact reduced the grammatical import of" items inside the parentheses "when it replaced commas cordoning off . . . the predecessor provision with the parentheses that now appear."). And this Court has similarly interpreted parenthetical phrases as "emphasiz[ing] the fact that that which is within is meant simply to be illustrative," *Chickasaw Nation v. United States*, 534 U.S. 84, 89 (2001), and to "partake of the nature" of items outside the parentheticals. *Pinellas Ice & Cold Storage Co. v. Commissioner*, 287 U.S. 462, 469-70 (1933). Here, the reference to "adjusted basis" simply illustrates a type of valuation misstatement, *i.e.*, a factual misrepresentation of the cost or value of an item. It does not change the ordinary meaning of valuation misstatement.

This construction makes perfect sense. While in the abstract, "adjusted basis" could be portrayed as a more expansive concept, in context it refers to fact-based basis errors. After all, basis originates in the "cost" of property, 26 U.S.C. § 1012(a), a concept that also depends on valuation. And the government itself acknowledges that the the "more commonplace basis errors" involve "factual misrepresentations about a

particular purchase price or value." U.S. Br. 24. For example, a homeowner takes an initial basis equal to the valuation determined by the purchase price in a bona fide arm's-length transaction. And the homeowner's adjusted basis may change in light of other transactions that depend on valuations, such as adding a bathroom or replacing the roof. *See, e.g., Ettig v. Commissioner*, 55 T.C.M. (CCH) 720 (1988).

Congress's use of "or" in "(or the adjusted basis of any property)" is consistent with the illustrative function of the parenthetical. In addition to the use that connotes difference, "or" also frequently introduces a term with similar meaning (or a synonym). Scalia & Garner, *Reading Law* 122. Courts have accordingly recognized that "or" can introduce an illustrative or merely explanatory phrase. *See, e.g., Mizrahi v. Gonzales*, 492 F.3d 156, 166 (2d Cir. 2007) ("[T]he disjunctive parenthetical here at issue need not be assigned a different meaning from the preceding language to avoid being surplusage; it can reasonably be construed to illustrate or explain the broader proposition.") This use of "or" dovetails with the use of parentheses in § 6662(e)(1)(A) to set off the clause.

Respondents' reading of the penalty gives effect to both Congress's pointed use of "valuation" *and* its parenthetical reference to "adjusted basis." The government's interpretation asks this Court to take the dependent reference to "adjusted basis" and transform the penalty from a "valuation misstatement" penalty into a "basis-overstatement" penalty that is in no way dependent on a *valuation* error—essentially blowing it

up and transforming it into a penalty scarcely recognizable to the one Congress intended.[7]

c. The structure and context of the valuation misstatement penalty confirm that it applies only to valuation errors—and not legal errors—that affect adjusted basis. When penalties can apply to *legal* errors, Congress and Treasury have typically provided defenses specifically for *legal* close calls. For example, the substantial understatement penalty in § 6662(b)(2) does not apply to the extent that there "was substantial authority" for tax treatment of items resulting in an understatement, which includes legal errors. 26 U.S.C. § 6662(d)(2)(B)(i); *see also* 26 C.F.R. § 1.6662-4(d)(2) ("substantial authority standard" involves "an analysis of the law"). In addition to the "substantial authority" defense, the Code provides a "reasonable basis" defense with respect to legal errors when the "relevant facts affecting the item's tax treatment" are disclosed. 26 U.S.C. § 6662(d)(2)(B)(ii); *see also* 26 C.F.R. § 1.6662-3(b)(3). Other penalties that cover legal errors provide similar defenses, including the penalty for negligence (26 U.S.C. § 6662(b)(1)). Consistent with the fact that Congress did not intend to reach legal errors with the valuation misstatement penalty, there is no specifically legal defense.[8]

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[7] The reference to "adjusted basis" at the end of § 6662(e)(1)(A) must be read in light of the preceding parenthetical, and thus does not support the government's reading either. It is noteworthy, though, that Congress used "correct amount"—a valuation concept—to refer to both "valuation or adjusted basis" at the end of the provision.

[8] While there is a "reasonable cause" defense available to most of the § 6662 penalties, 26 U.S.C. § 6664(c)(1)-(2), that defense is not *specific* to legal mistakes, *see* 26 C.F.R. § 1.6664-

The absence of specifically legal defense is particularly striking given that the government's interpretation would subject a broad swath of legal mistakes to the penalty. If this Court adopts the government's "basis-overstatement penalty," the IRS may seek to impose penalties on myriad other legal errors affecting adjusted basis that have nothing to do with valuation misstatements, such as failing to take allowable depreciation, associating liabilities with unassociated assets, or failing to account for the effect of certain distributions that reduce basis. *See* Shakow, *supra*, at 1285 (listing examples). Indeed, the government admits that it could apply the penalty (under its theory) in other novel contexts involving no "factual error" but only the "misapplication of basis-computation rules," such as those in the consolidated return regulations. U.S. Br. 42.

Application of the valuation misstatement penalty to legal errors in the computation of basis is also inconsistent with the penalty's graduated structure. The penalty has always been calibrated to become more severe as the numerical degree of value or basis overstatement increases. *See* 26 U.S.C. § 6662(h)(2)(A) (20% penalty for 150% overstatement; 40% for 200% overstatement); *see also id.* § 6659 (1981) (10% penalty for 150% overstatement; 20% for 200% overstatement; 30% for 250% overstatement). But when transactions are "shammed" under the economic substance doctrine (or basis is invalidated based on other legal errors) the penalty operates like an on/off switch, because the

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4(b)(1), and there is no reason to conclude that Congress intended to put taxpayers whose legal mistakes lead to misstatements of basis at a disadvantage compared to taxpayers whose legal errors give rise to other penalties with specifically legal defenses.

basis is reduced to "zero" in this situation, which makes it mathematically impossible to apply the penalty's graduated scale. Thus, under the government's theory, the maximum 40% penalty will apply in *every case* that presents such a legal dispute—effectively eliminating the penalty's carefully structured, graduated scheme.

3. The Legal Question Whether To "Sham" An Accurately Reported Transaction For Lack Of Economic Substance Is Unrelated To Valuation Misstatements

The economic substance doctrine has nothing to do with the valuation misstatement that triggers the penalty. Before its codification in 2010, courts applied the economic substance doctrine as judge-made law to disregard transactions for tax purposes even when they complied with the literal terms of the Code. *See, e.g.*, *Coltec Indus., Inc. v. United States*, 454 F.3d 1340, 1353-54 (Fed. Cir. 2006), *cert. denied*, 549 U.S. 1206 (2007). The determination whether a transaction lacks economic substance is a question of law. *Frank Lyon Co. v. United States*, 435 U.S. 561, 581 n.16 (1978); *accord* U.S. Br. at 9-10, *Sala v. United States*, 132 S. Ct. 91 (2011) (No. 10-1047), 2011 WL 2159626. The doctrine thus does not turn at all on the sort of fact-based *valuation* problems that the valuation misstatement penalty was intended to address.

This case illustrates the difference. The options purchased by Woods and McCombs (and subsequently contributed to the partnerships) were the only partnership items actually subject to a valuation exercise. But the government has conceded that the cost or value of those purchase options was precisely equal to their reported basis. *See supra* at 16. In other words, the government has conceded that respondents

did not make any "factual misrepresentations about a particular purchase price or value." U.S. Br. 24. The only ground that the government and the district court have identified for disregarding the tax consequences of the transactions is that they lacked economic substance, *see id.*; Pet. App. 19a-20a, and the application of the penalty to that purely legal error is the only merits question presented, U.S. Br. i.

The government contends that because there was no economic substance, the taxpayers must have overstated their outside basis. U.S. Br. 41. But this syllogism simply assumes that any basis overstatement is a valuation misstatement and, thus, fails to account for the ordinary meaning of *valuation*. *Supra* at 34. No valuation is necessary to determine whether "'a transaction lacks economic substance compelled by business or regulatory realities.'" Pet. App. 19a-20a (quoting *Klamath Strategic Inv. Fund v. United States*, 568 F.3d 537, 544 (5th Cir. 2009)). The government recognizes (at 41) the critical difference between basis overstatements based on valuation misstatements and on legal errors, but never addresses why the economic substance doctrine actually results in a *valuation misstatement*. That failure is fatal.

4. Congress's Subsequent Action Confirms That The Valuation Misstatement Penalty Was Not Intended To Address The Situation Presented Here

Congress's recent actions remove any doubt that the valuation misstatement penalty was not intended to apply to basis overstatements caused by a legal determination that a transaction lacks economic substance. As discussed, in 2010, Congress specifically addressed this distinct issue by creating a separate

"noneconomic substance transaction" penalty. 26 U.S.C. § 6662(b)(6), (i) (2010); *see supra* at 12. Moreover, although Congress adopted a graduated scheme for that penalty, the trigger for the greater penalty is whether the transaction was properly disclosed—as opposed to valuation concepts that are mathematically meaningless when a transaction is "shammed" for lack of economic substance.

The addition of the "non-economic substance transaction penalty" in 2010 as a stand-alone provision "sheds light upon the meaning of" the earlier valuation misstatement penalty. *See Branch v. Smith*, 538 U.S. 254, 280-81 (2003) (plurality opinion); *see also United States v. Freeman*, 44 U.S. (3 How.) 556, 564-65 (1845) ("[I]f it can be gathered from a subsequent statute *in pari materia*, what meaning the [later] legislature attached to the words of a former statute, they will amount to a legislative declaration of its meaning, and will govern the construction of the first statute."); Scalia & Garner, *Reading Law* 254-55 ("[T]he meaning of an ambiguous provision may change in light of a subsequent enactment."). If Congress had adopted the broad-based "basis-overstatement penalty" advanced by the government, there would have been no need for Congress to adopt this new penalty.

The manner in which Congress acted is also telling. Rather than amending the valuation misstatement penalty to make clear that it is triggered by basis adjustments resulting from the legal invalidation of "non-economic substance transactions," Congress enacted an entirely new and different penalty. Section 6662 continues to set forth the valuation misstatement penalty in one silo (§ 6662(b)(3), (e), (h)), and the new "non-economic substance transaction" penalty in

another (§ 6662(b)(6), (i)). The new penalty in no way refers to "valuation" or any other language reminiscent of the substantial valuation misstatement penalty. Of course, that is perfectly consistent with the fact that the valuation misstatement penalty was never designed, or intended, to cover the situation at issue here. And Congress's action in 2010—which, remarkably, never sees the light of day in the government's brief—utterly belies the government's position that basis overstatements resulting from legally "shammed" transactions have been covered all along by the valuation misstatement penalty.

B. An Underpayment Stemming From A Legal Determination That A Transaction Lacks Economic Substance Is Not "Attributable To" Any Valuation Misstatement

The valuation misstatement penalty is inapplicable in this case for another reason: it only applies to "the portion of any underpayment which is *attributable to* . . . [a] substantial valuation misstatement." 26 U.S.C. § 6662(b)(3) (emphasis added). When an independent legal ground (such as the "shamming" of a transaction under the economic substance doctrine) renders a deduction *of any size* improper, a valuation misstatement is irrelevant to a taxpayer's liability for taxes. The underpayment in such a case—as the court of appeals has correctly held—simply is *not* "attributable to" any valuation misstatement.

1. The government correctly recognizes (at 39-40) that an underpayment is only "attributable to" a valuation misstatement if that misstatement caused the underpayment. Yet without defining what sort of causation satisfies the statutory requirement, the

government assumes (at 40-41) that there is a sufficient causal link in this case. That is incorrect.

The ordinary meaning of "attributable to" is "resulting from" or "caused by." *See Webster's Third New Int'l Dictionary* 141-42 (1981) (defining "attribute" as "to explain as caused or brought about by"); *American Heritage Dictionary of the English Language* 85 (1981) ("[t]o regard or assign as . . . resulting from someone or something"). An underpayment triggered by a legal determination that a transaction should be disregarded under the economic substance doctrine does not "result from"—and is not "caused by"—a valuation misstatement, when the reason that the underlying deduction or loss is disallowed is that the transaction was "shammed" (and any attendant gains or losses are thus erased).

The IRS's or a court's determination that a deduction or loss resulting in the underpayment is legally inapplicable altogether as a result of the "shamming" a transaction under the economic substance doctrine cuts off any causal relationship between any valuation misstatement and the underpayment. *See Bemont Invs., L.L.C. v. United States*, 679 F.3d 339, 347-48 (5th Cir. 2012) ("Because the IRS treated the transactions as a sham, and disallowed all tax attributes flowing from the transactions in full, any valuation misstatement was irrelevant to the calculation of the tax . . . .").

Stretching "attributable to" any further would conflict with the aim of the statute. In cases where there *is* a genuine valuation dispute, the government's interpretation of "attributable to" would "force" a court to decide valuation issues for the sole purpose of imposing a valuation misstatement penalty, *Todd v.*

Commissioner, 862 F.2d at 543-45 & n.14—even when the court knows that the deduction or loss is disallowed altogether under the economic substance doctrine. *See also Keller v. Commissioner*, 556 F.3d 1056, 1061 (9th Cir. 2009) ("When a depreciation deduction is disallowed in total, any overvaluation is subsumed in that disallowance, and an associated tax underpayment is 'attributable to' the invalid deduction, not the overvaluation of the asset."). Forcing courts or the IRS to resolve disputes over the value of property when they are unnecessary to determine tax liability would be thoroughly inconsistent with Congress's goal of easing—rather than cluttering—the Tax Court's docket of such valuation disputes.[9]

2. This interpretation is strongly supported by the guidance prepared by the staff of the Joint Committee on Taxation in its *General Explanation of the Economic Recovery Tax Act of 1981* (*Blue Book*). This Court has stated that the Blue Book "provides a compelling contemporary indication" of the meaning of the statute. *Federal Power Comm'n v. Memphis Light, Gas & Water Div.*, 411 U.S. 458, 472 (1973). And—despite questioning its probative value here (at 46)—the government has itself relied on the Blue Book as evidence of Congress's intent, since "it contains the views of the committee staff which participated in

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[9] The conception of causation appropriate for any particular statutory provision or scheme must be interpreted in light of the context and purposes of that statute. *See, e.g., Holmes v. Securities Investor Prot. Corp.*, 503 U.S. 258, 266 (1992); *Blue Shield of Va. v. McCready*, 457 U.S. 465, 476-77 (1982).

every step of the legislative process."[10] The Blue Book states that "[t]he portion of a tax underpayment that is attributable to a valuation misstatement will be determined *after taking into account any other proper adjustments to tax liability.*" *Blue Book* at 333 (emphasis added). Accordingly, there is no underpayment attributable to a valuation misstatement (and hence no valuation misstatement penalty) if a tax rule—like the economic substance doctrine—requires an adjustment to tax liability that, by itself, results in the disallowance of the claimed tax benefits. *See Todd*, 862 F.3d at 542-43.

The economic substance doctrine here operates as precisely the sort of "other proper adjustment to tax liability" that the Blue Book refers to—that is, an independent legal ground for disallowing a deduction aside from a valuation misstatement. The district court treated the operation of the economic substance doctrine as fatal *in and of itself* to the reported losses, rather than as one link in a chain of causation that eventually led to a valuation misstatement: "[The transaction] was totally lacking in economic substance and was for the sole purpose of creating a tax benefit. Therefore, both the ordinary loss and the capital loss claimed by the respective partnerships should be disregarded for tax purposes." Pet. App. 21a. The court did not endorse the government's own "'Tinker to Evers to Chance' routine" that reconstructed the

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[10] U.S. Br. 24, *Allbritton v. Commissioner*, 37 F.3d 183 (5th Cir. 1994) (No. 94-40277), 1994 WL 16510112; *see, e.g.*, U.S. Br. 5 n.7, 27 n.19, *United States v. Carlton*, 512 U.S. 26 (1994) (No. 92-1941), 1993 WL 638225 (Nov. 15, 1993); Pet. for Writ of Certiorari 28, *Commissioner v. Soliman*, 506 U.S. 168 (1993) (No. 91-998).

transaction in a way that caused a valuation misstatement, which in turn caused the reported losses—it simply disallowed the losses outright. *Id.*; *see also* U.S. Br. 47-48. Therefore, just as in *Todd*, there is no reason to require an otherwise unnecessary valuation because an independent legal ground resolves the dispute over tax liability on its own.

3. The government claims that Treasury regulations should resolve any dispute over which underpayments are "attributable to" valuation misstatements. U.S. Br. 42-43. But those regulations are entirely silent on the central question: *whether* an underpayment is "attributable to" a valuation misstatement in the situation presented here.

26 C.F.R. § 1.6662-5(g) states that the "value or adjusted basis claimed on a return of any property with a correct value or adjusted basis of zero is considered to be 400 percent or more of the correct amount" and therefore "[t]here is a gross valuation misstatement with respect to such property." The regulation's only function is to "help[] determine whether a valuation misstatement is a gross misstatement" when "true basis is determined to be zero" and the misstatement percentage would otherwise be mathematically undefined. *Bemont Invs.*, 679 F.3d at 348 n.5. It does not address whether or when an underpayment is "attributable to" a valuation misstatement, and it "does not purport to negate" cases finding underpayments *not* attributable to valuation misstatements. *Id.* The regulation provides no hook on which the government can hang its claim to *Chevron* deference.

More generally, the Treasury regulations at most parrot the statute in relevant respects. *See* 26 C.F.R. § 1.6662-5. No deference to an administrative

interpretation is due "when, instead of using its expertise and experience to formulate a regulation, it has elected merely to paraphrase the statutory language." *Gonzales v. Oregon*, 546 U.S. 243, 257 (2006). And because "'Congress has delegated to the administrative official and not to appellate counsel the responsibility for elaborating and enforcing statutory commands,'" no deference is due to the government's litigating position that the valuation misstatement penalty applies here. *Bowen v. Georgetown Univ. Hosp.*, 488 U.S. 204, 212 (1988) (citation omitted).

C. Any Doubt As To Whether The Valuation Misstatement Penalty Applies Here Must Be Resolved In Favor Of The Taxpayers

Although they do not help the government here, the government frequently has a significant advantage in litigation against its citizens in the form of doctrines according deference to its interpretations or resolving ambiguities in its favor. The government is not shy about invoking those rules, and often rests on them. In this context, however, the shoe is on the other foot.

History proves all too well that "the power to tax involves the power to destroy." *McCulloch v. Maryland*, 17 U.S. (4 Wheat.) 316, 431 (1819) (Marshall, C.J.). This Court therefore has long taken special care to ensure that the tax laws are not abused. And one way of doing so is insisting that the tax laws should "'be intelligible to those who are expected to obey them.'" *White v. Aronson*, 302 U.S. 16, 20-21 (1937) (citation omitted). Accordingly, this Court has repeatedly held that, "if doubt exists as to the construction of a taxing statute, the doubt should be resolved in favor of the taxpayer." *Hassett v. Welch*,

303 U.S. 303, 314 (1938); *Old Colony R.R. Co. v. Commissioner*, 284 U.S. 552, 561 (1932) ("If there were doubt as to connotation of the term, and another meaning might be adopted, the fact of its use in a tax statute would incline the scale to the construction most favorable to the taxpayer."); *see also United Dominion Indus., Inc. v. United States*, 532 U.S. 822, 839 (2001) (Thomas, J., concurring) ("'When the tax gatherer puts his finger on the citizen, he must also put his finger on the law permitting it'" (citation omitted)).

Application of that canon is especially important when it comes to the government's efforts to impose *penalties* on its citizens for failure to obey the tax laws. As Chief Justice Marshall observed, "penal laws are to be construed strictly" because "the power of punishment is vested in the legislative, not in the judicial department." *United States v. Wiltberger*, 18 U.S. (5 Wheat.) 76, 95 (1820). This Court has accordingly held that tax penalties are "to be strictly construed," *Ivan Allen Co. v. United States*, 422 U.S. 617, 627 (1975), and admonished that no taxpayer is "'to be subjected to a penalty unless the words of the statute plainly impose it.'" *Commissioner v. Acker*, 361 U.S. 87, 91 (1959) (citations omitted).

At a minimum, the valuation misstatement penalty does not "plainly impose" the all-encompassing "basis-overstatement penalty" that the government asks this Court to adopt in this case. That is reason enough to reject the government's interpretation. When the government is wielding the "power to destroy," the *citizen* gets the benefit of the doubt.

III. CONGRESS HAS ALREADY ADDRESSED THE GOVERNMENT'S POLICY CONCERNS

In the end, the government makes what amounts to a policy plea to this Court to adopt the all-encompassing "basis-overstatement penalty" that the government has devised to reach what the government views as "far more egregious conduct" (at 26) than the sort of factual misrepresentations of property or price that Congress clearly had in mind when it enacted the "valuation misstatement penalty." U.S. Br. 26, 49. But this Court's duty is of course to interpret the law that Congress has enacted, not the law that the IRS—with the benefit of hindsight—*wishes* Congress had enacted. Especially in view of the strict-construction canon discussed above, such policy arguments could never provide a basis for disregarding—or expanding—the penalty that Congress actually enacted. And that is especially true here, where Congress has already acted to address the government's policy concerns.

The transaction targeted by the IRS here would fall cleanly within the "noneconomic substance transaction" penalty added by Congress in 2010. 26 U.S.C. § 6662(b)(6), (i). Because the losses at issue were disallowed "by reason of a transaction lacking economic substance," the 20% accuracy-related penalty would apply. *Id.* § 6662(b)(6). And because the taxpayers did not disclose the facts relevant to the tax treatment of the transaction on the mandatory form, the 40% penalty would kick in too. *Id.* § 6662(i)(1)-(2). Today, there is no question that the IRS has the statutory authority to penalize that transaction.

True, Congress declined to make this new penalty retroactive. It only applies to transactions entered into *after* the date of the enactment of the Act, and so does

not apply to the transactions at issue here. But Congress was certainly free to adopt this new penalty only on a prospective basis. There is no reason for this Court to transform the "valuation misstatement penalty" that Congress adopted decades earlier into the government's "basis-overstatement penalty" just so the government can mop up whatever enforcement issues might exist with respect to transactions that took place before the effective date of the 2010 Act for which the three-year statute of limitations in 26 U.S.C. § 6501(a) has not already run in 2013.

Moreover, even before Congress gave the IRS the power to penalize noneconomic substance transactions, the IRS had a potent tool for addressing situations like this. For taxable years after 2004, the "reportable transaction understatement penalty" imposed a 20% penalty on any understatement of taxes attributable to certain kinds of tax avoidance transactions known as "listed transactions" or "reportable transactions." American Jobs Creation Act of 2004, Pub. L. No. 108-357, § 812, 118 Stat. 1418, 1577 (codified at 26 U.S.C. § 6662A). The transaction at issue in this case became a "listed transactions" in 2000. I.R.S. Notice 2000-44, 2000-2 C.B. 255, 256. In addition, there is the possibility of the 20% negligence penalty, which the IRS has determined applies in this case. JA 96, 150.

If this transaction took place today, the IRS has taken the position that it may impose a 20% reportable transaction understatement penalty *on top of* certain other 20% accuracy-related penalties properly determined in partner-level proceedings, such as the penalty for negligence. *See* I.R.S. Chief Counsel Mem. at 4 (PMTA 2010-55) (Aug. 24, 2010), *available at* http://www.irs.gov/pub/lanoa/pmta_2010-55.pdf

(concluding that § 6662A penalty applies in addition to § 6662 penalties not explicitly referenced in § 6662A(e). That would allow the IRS to seek the same aggregate 40% penalty sought in this case. On top of that, Congress has also given the IRS the power to penalize taxpayers for failing to file a disclosure statement notifying the IRS that they have participated in a listed transaction. *See* 26 U.S.C. § 6707A.

In short, Congress has given the IRS ample weapons to attack, and prevent, transactions deemed to lack economic substance. Accordingly, in deciding this case, this Court may give effect to the "valuation misstatement" penalty that Congress actually enacted secure in the knowledge that Congress has served its coordinate role as well by updating the penalties to address the different issue presented here.[11]

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[11] Nor is there any reason for this Court to rewrite the valuation misstatement penalty to address the government's Orwellian sense of taxpayer fairness, under which the "fairest" tax penalty apparently is the one that can be imposed on the *most* taxpayers. U.S. Br. 26, 49. There is nothing "unfair" or "anomal[ous]" (*id.* at 48–49) about Congress taking an incremental approach to penalties, or to crafting different penalties to address different issues (as it ultimately did here).

CONCLUSION

The judgment of the court of appeals on the applicability of the valuation misstatement penalty should be vacated for lack of jurisdiction and the case remanded so that the district court may consider whether any other action is necessary or appropriate. In the alternative, the judgment should be affirmed.

Respectfully submitted,

JOEL N. CROUCH
MEADOWS, COLLIER, REED, COUSINS, CROUCH & UNGERMAN LLP
901 Main Street
Suite 3700
Dallas, TX 75202

GREGORY G. GARRE
Counsel of Record
BRIAN D. SCHMALZBACH
KATYA S. CRONIN
LATHAM & WATKINS LLP
555 Eleventh Street, NW
Suite 1000
Washington, DC 20004
(202) 637-2207
gregory.garre@lw.com

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26 U.S.C. § 6221

§ 6221. Tax treatment determined at partnership level

Except as otherwise provided in this subchapter, the tax treatment of any partnership item (and the applicability of any penalty, addition to tax, or additional amount which relates to an adjustment to a partnership item) shall be determined at the partnership level.

26 U.S.C. § 6226

§ 6226. Judicial review of final partnership administrative adjustments

(a) Petition by tax matters partner

Within 90 days after the day on which a notice of a final partnership administrative adjustment is mailed to the tax matters partner, the tax matters partner may file a petition for a readjustment of the partnership items for such taxable year with—

(1) the Tax Court,

(2) the district court of the United States for the district in which the partnership's principal place of business is located, or

(3) the Court of Federal Claims.

* * *

(f) Scope of judicial review.

A court with which a petition is filed in accordance with this section shall have jurisdiction to determine all partnership items of the partnership for the partnership taxable year to which the notice of final partnership administrative adjustment relates, the proper allocation of such items among the partners, and the applicability of any penalty, addition to tax, or additional amount which relates to an adjustment to a partnership item.

* * *

26 U.S.C. § 6230

§ 6230. Additional administrative provisions

(a) Coordination with deficiency proceedings.

(1) In general.

Except as provided in paragraph (2) or (3), subchapter B of this chapter shall not apply to the assessment or collection of any computational adjustment.

(2) Deficiency proceedings to apply in certain cases.

(A) Subchapter B shall apply to any deficiency attributable to—

(i) affected items which require partner level determinations (other than penalties, additions to tax, and additional amounts that relate to adjustments to partnership items), or

(ii) items which have become nonpartnership items (other than by reason of section 6231(b)(1)(C)) and are described in section 6231(e)(1)(B).

(B) Subchapter B shall be applied separately with respect to each deficiency described in subparagraph (A) attributable to each partnership.

(C) Notwithstanding any other law or rule of law, any notice or proceeding under subchapter B with respect to a deficiency described in this paragraph shall not preclude or be precluded by any other notice, proceeding, or determination with respect to a partner's tax liability for a taxable year.

(3) Special rule in case of assertion by partner's spouse of innocent spouse relief.

(A) Notwithstanding section 6404(b), if the spouse of a partner asserts that section 6015 applies with respect to a liability that is attributable to any adjustment to a partnership item (including any liability for any penalties, additions to tax, or additional amounts relating to such adjustment), then such spouse may file with the Secretary within 60 days after the notice of computational adjustment is mailed to the spouse a request for abatement of the assessment specified in such notice. Upon receipt of such request, the Secretary shall abate the assessment. Any reassessment of the tax with respect to which an abatement is made under this subparagraph shall be subject to the deficiency procedures prescribed by subchapter B. The period for making any such reassessment shall not expire before the expiration of 60 days after the date of such abatement.

(B) If the spouse files a petition with the Tax Court pursuant to section 6213 with respect to the request for abatement described in subparagraph (A), the Tax Court shall only have jurisdiction pursuant to this section to determine whether the requirements of section 6015 have been satisfied. For purposes of such determination, the treatment of partnership items (and the applicability of any penalties, additions to tax, or additional amounts) under the settlement, the final partnership administrative adjustment, or the decision of the court (whichever is appropriate) that gave rise to the liability in question shall be conclusive.

(C) Rules similar to the rules contained in subparagraphs (B) and (C) of paragraph (2) shall apply for purposes of this paragraph.

(b) Mathematical and clerical errors appearing on partnership return

(1) In general

Section 6225 shall not apply to any adjustment necessary to correct a mathematical or clerical error (as defined in section 6213(g)(2)) appearing on the partnership return.

(2) Exception

Paragraph (1) shall not apply to a partner if, within 60 days after the day on which notice of the correction of the error is mailed to the partner, such partner files with the Secretary a request that the correction not be made.

(c) Claims arising out of erroneous computations, etc.

(1) In general

A partner may file a claim for refund on the grounds that—

(A) the Secretary erroneously computed any computational adjustment necessary—

(i) to make the partnership items on the partner's return consistent with the treatment of the partnership items on the partnership return, or

(ii) to apply to the partner a settlement, a final partnership administrative adjustment, or the decision of a court in an action brought under section 6226 or section 6228(a),

(B) the Secretary failed to allow a credit or to make a refund to the partner in the amount of

the overpayment attributable to the application to the partner of a settlement, a final partnership administrative adjustment, or the decision of a court in an action brought under section 6226 or section 6228(a), or

(C) the Secretary erroneously imposed any penalty, addition to tax, or additional amount which relates to an adjustment to a partnership item.

(2) Time for filing claim

(A) Under paragraph (1)(A) or (C)

Any claim under subparagraph (A) or (C) of paragraph (1) shall be filed within 6 months after the day on which the Secretary mails the notice of computational adjustment to the partner.

(B) Under paragraph (1)(B)

Any claim under paragraph (1)(B) shall be filed within 2 years after whichever of the following days is appropriate:

(i) the day on which the settlement is entered into,

(ii) the day on which the period during which an action may be brought under section 6226 with respect to the final partnership administrative adjustment expires, or

(iii) the day on which the decision of the court becomes final.

(3) Suit if claim not allowed.

If any portion of a claim under paragraph (1) is not allowed, the partner may bring suit with respect to such portion within the period specified in subsection (a) of section 6532 (relating to periods of limitations on refund suits).

(4) No review of substantive issues

For purposes of any claim or suit under this subsection, the treatment of partnership items on the partnership return, under the settlement, under the final partnership administrative adjustment, or under the decision of the court (whichever is appropriate) shall be conclusive. In addition, the determination under the final partnership administrative adjustment or under the decision of the court (whichever is appropriate) concerning the applicability of any penalty, addition to tax, or additional amount which relates to an adjustment to a partnership item shall also be conclusive. Notwithstanding the preceding sentence, the partner shall be allowed to assert any partner level defenses that may apply or to challenge the amount of the computational adjustment.

(5) Rules for seeking innocent spouse relief

(A) In general

The spouse of a partner may file a claim for refund on the ground that the Secretary failed to relieve the spouse under section 6015 from a liability that is attributable to an adjustment to a partnership item (including any liability for any penalties, additions to tax, or additional amounts relating to such adjustment).

(B) Time for filing claim

Any claim under subparagraph (A) shall be filed within 6 months after the day on which the Secretary mails to the spouse the notice of computational adjustment referred to in subsection (a)(3)(A).

(C) Suit if claim not allowed

If the claim under subparagraph (B) is not allowed, the spouse may bring suit with respect to the claim within the period specified in paragraph (3).

(D) Prior determinations are binding

For purposes of any claim or suit under this paragraph, the treatment of partnership items (and the applicability of any penalties, additions to tax, or additional amounts) under the settlement, the final partnership administrative adjustment, or the decision of the court (whichever is appropriate) that gave rise to the liability in question shall be conclusive.

* * *

26 U.S.C. § 6231

§ 6231. Definitions and special rules

(a) Definitions

For purposes of this subchapter—

(1) Partnership

(A) In general.

Except as provided in subparagraph (B), the term "partnership" means any partnership required to file a return under section 6031(a).

(B) Exception for small partnerships

(i) In general

The term "partnership" shall not include any partnership having 10 or fewer partners each of whom is an individual (other than a non-resident alien), a C corporation, or an estate of a deceased partner. For purposes of the preceding sentence, a husband and wife (and their estates) shall be treated as 1 partner.

(ii) Election to have subchapter apply.

A partnership (within the meaning of subparagraph (A)) may for any taxable year elect to have clause (i) not apply. Such election shall apply for such taxable year and all subsequent taxable years unless revoked with the consent of the Secretary.

(2) Partner.

The term "partner" means—

(A) a partner in the partnership, and

(B) any other person whose income tax liability under subtitle A is determined in whole or in part

by taking into account directly or indirectly partnership items of the partnership.

(3) Partnership item.

The term "partnership item" means, with respect to a partnership, any item required to be taken into account for the partnership's taxable year under any provision of subtitle A to the extent regulations prescribed by the Secretary provide that, for purposes of this subtitle, such item is more appropriately determined at the partnership level than at the partner level.

(4) Nonpartnership item.

The term "nonpartnership item" means an item which is (or is treated as) not a partnership item.

(5) Affected item.

The term "affected item" means any item to the extent such item is affected by a partnership item.

(6) Computational adjustment.

The term "computational adjustment" means the change in the tax liability of a partner which properly reflects the treatment under this subchapter of a partnership item. All adjustments required to apply the results of a proceeding with respect to a partnership under this subchapter to an indirect partner shall be treated as computational adjustments.

(7) Tax matters partner.

The tax matters partner of any partnership is—

(A) the general partner designated as the tax matters partner as provided in regulations, or

(B) if there is no general partner who has been so designated, the general partner having

the largest profits interest in the partnership at the close of the taxable year involved (or, where there is more than 1 such partner, the 1 of such partners whose name would appear first in an alphabetical listing).

If there is no general partner designated under subparagraph (A) and the Secretary determines that it is impracticable to apply subparagraph (B), the partner selected by the Secretary shall be treated as the tax matters partner. The Secretary shall, within 30 days of selecting a tax matters partner under the preceding sentence, notify all partners required to receive notice under section 6223(a) of the name and address of the person selected.

* * *

26 U.S.C. § 6659
(Pub. L. No. 97-34, tit. VII, § 722, 95 Stat. 172, 341)

SEC. 722. ADDITIONS TO TAX IN THE CASE OF VALUATION OVERSTATEMENTS, INCREASE IN NEGLIGENCE PENALTY.

(a) Valuation Overstatements.—,

(1) In general.—Subchapter A of chapter 68 (relating to additions to tax) is amended by redesignating section 6659 as section 6660 and by inserting after section 6658 the following new section:

"SEC. 6659. ADDITION TO TAX IN THE CASE OF VALUATION OVERSTATEMENTS FOR PURPOSES OF THE INCOME TAX.

"(a) Addition to the Tax.—If—,

"(1) an individual, or

"(2) a closely held corporation or a personal service corporation,

has an underpayment of the tax imposed by chapter 1 for the taxable year which is attributable to a valuation overstatement, then there shall be added to the tax an amount equal to the applicable percentage of the underpayment so attributable.

"(b) Applicable Percentage Defined.—For purposes of subsection (a), the applicable percentage shall be determined under the following table:

"If the valuation claimed is the following percent of the correct valuation—	The applicable percentage is
150 percent or more but not more than 200 percent	10
More than 200 percent but not more than 250 percent	20
More than 250 percent	30

"(c) Valuation Overstatement Defined.—,

"(1) In general.—For purposes of this section, there is a valuation overstatement if the value of any property, or the adjusted basis of any property, claimed on any return exceeds 150 percent of the amount determined to be the correct amount of such valuation or adjusted basis (as the case may be).

"(2) Property must have been acquired within last 5 years.—This section shall not apply to any property which, as of the close of the taxable year for which there is a valuation overstatement, has been held by the taxpayer for more than 5 years.

"(d) Underpayment Must Be at Least $1,000.—This section shall not apply if the underpayment for the taxable year attributable to the valuation overstatement is less than $1,000.

"(e) Authority To Waive.—The Secretary may waive all or any part of the addition to the tax provided by this section on a showing by the taxpayer that there was a reasonable basis for the valuation or adjusted basis claimed on the return and that such claim was made in good faith.

"(f) Other Definitions.—For purposes of this section—,

"(1) Underpayment.—The term 'underpayment' has the meaning given to such term by section 6653(c)(1).

"(2) Closely held corporation.—The term 'closely held corporation' means any corporation described in section 465(a)(1)(C).

"(3) Personal service corporation.—The term 'personal service corporation' means any corporation which is a service organization (within the meaning of section 414(m)(3))."

* * *

26 U.S.C. § 6662 (2000)

§ 6662. Imposition of accuracy-related penalty on underpayments

(a) Imposition of penalty.

If this section applies to any portion of an underpayment of tax required to be shown on a return, there shall be added to the tax an amount equal to 20 percent of the portion of the underpayment to which this section applies.

(b) Portion of underpayment to which section applies.

This section shall apply to the portion of any underpayment which is attributable to 1 or more of the following:

(1) Negligence or disregard of rules or regulations.

(2) Any substantial understatement of income tax.

(3) Any substantial valuation misstatement under chapter 1.

(4) Any substantial overstatement of pension liabilities.

(5) Any substantial estate or gift tax valuation understatement.

This section shall not apply to any portion of an underpayment on which a penalty is imposed under section 6663.

* * *

(e) Substantial valuation misstatement under chapter 1

(1) In general

For purposes of this section, there is a substantial valuation misstatement under chapter 1 if—

(A) the value of any property (or the adjusted basis of any property) claimed on any return of tax imposed by chapter 1 is 200 percent or more of the amount determined to be the correct amount of such valuation or adjusted basis (as the case may be), or

(B)(i) the price for any property or services (or for the use of property) claimed on any such return in connection with any transaction between persons described in section 482 is 200 percent or more (or 50 percent or less) of the amount determined under section 482 to be the correct amount of such price, or

(ii) the net section 482 transfer price adjustment for the taxable year exceeds the lesser of $5,000,000 or 10 percent of the taxpayer's gross receipts.

(2) Limitation.

No penalty shall be imposed by reason of subsection (b)(3) unless the portion of the underpayment for the taxable year attributable to substantial valuation misstatements under chapter 1 exceeds $5,000 ($10,000 in the case of a corporation other than an S corporation or a personal holding company (as defined in section 542)).

* * *

(h) Increase in penalty in case of gross valuation misstatements

(1) In general

To the extent that a portion of the underpayment to which this section applies is attributable to one or more gross valuation misstatements, subsection (a) shall be applied with respect to such portion by substituting "40 percent" for "20 percent".

(2) Gross valuation misstatements

The term "gross valuation misstatements" means—

(A) any substantial valuation misstatement under chapter 1 as determined under subsection (e) by substituting—

(i) "400 percent" for "200 percent" each place it appears,

(ii) "25 percent" for "50 percent", and

(iii) in paragraph (1)(B)(ii)—

(I) "$20,000,000" for "$5,000,000", and

(II) "20 percent" for "10 percent".

(B) any substantial overstatement of pension liabilities as determined under subsection (f) by substituting "400 percent" for "200 percent", and

(C) any substantial estate or gift tax valuation understatement as determined under subsection (g) by substituting "25 percent" for "50 percent".

26 U.S.C. § 6662 (current)

§ 6662. Imposition of accuracy-related penalty on underpayments

(a) Imposition of penalty.

If this section applies to any portion of an underpayment of tax required to be shown on a return, there shall be added to the tax an amount equal to 20 percent of the portion of the underpayment to which this section applies.

(b) Portion of underpayment to which section applies.

This section shall apply to the portion of any underpayment which is attributable to 1 or more of the following:

(1) Negligence or disregard of rules or regulations.

(2) Any substantial understatement of income tax.

(3) Any substantial valuation misstatement under chapter 1.

(4) Any substantial overstatement of pension liabilities.

(5) Any substantial estate or gift tax valuation understatement.

(6) Any disallowance of claimed tax benefits by reason of a transaction lacking economic substance (within the meaning of section 7701(o)) or failing to meet the requirements of any similar rule of law.

(7) Any undisclosed foreign financial asset understatement.

This section shall not apply to any portion of an underpayment on which a penalty is imposed under section 6663. Except as provided in paragraph (1) or (2)(B) of section 6662A(e), this section shall not apply to the portion of any underpayment which is attributable to a reportable transaction understatement on which a penalty is imposed under section 6662A.

* * *

(e) Substantial valuation misstatement under chapter 1

(1) In general

For purposes of this section, there is a substantial valuation misstatement under chapter 1 if—

(A) the value of any property (or the adjusted basis of any property) claimed on any return of tax imposed by chapter 1 is 150 percent or more of the amount determined to be the correct amount of such valuation or adjusted basis (as the case may be), or

(B)(i) the price for any property or services (or for the use of property) claimed on any such return in connection with any transaction between persons described in section 482 is 200 percent or more (or 50 percent or less) of the amount determined under section 482 to be the correct amount of such price, or

(ii) the net section 482 transfer price adjustment for the taxable year exceeds the lesser of $5,000,000 or 10 percent of the taxpayer's gross receipts.

(2) Limitation

No penalty shall be imposed by reason of subsection (b)(3) unless the portion of the underpayment for the taxable year attributable to substantial valuation misstatements under chapter 1 exceeds $5,000 ($10,000 in the case of a corporation other than an S corporation or a personal holding company (as defined in section 542)).

* * *

(h) Increase in penalty in case of gross valuation misstatements

(1) In general

To the extent that a portion of the underpayment to which this section applies is attributable to one or more gross valuation misstatements, subsection (a) shall be applied with respect to such portion by substituting "40 percent" for "20 percent".

(2) Gross valuation misstatements

The term "gross valuation misstatements" means—

(A) any substantial valuation misstatement under chapter 1 as determined under subsection (e) by substituting—

(i) in paragraph (1)(A), "200 percent" for "150 percent",

(ii) in paragraph (1)(B)(i)—

(I) "400 percent" for "200 percent", and

(II) "25 percent" for "50 percent", and

(iii) in paragraph (1)(B)(ii)—

(I) "$20,000,000" for "$5,000,000", and

(II) "20 percent" for "10 percent".

(B) any substantial overstatement of pension liabilities as determined under subsection (f) by substituting "400 percent" for "200 percent", and

(C) any substantial estate or gift tax valuation understatement as determined under subsection (g) by substituting "40 percent" for "65 percent".

(i) **Increase in penalty in case of nondisclosed noneconomic substance transactions**

(1) In general.

In the case of any portion of an underpayment which is attributable to one or more nondisclosed noneconomic substance transactions, subsection (a) shall be applied with respect to such portion by substituting "40 percent" for "20 percent".

(2) Nondisclosed noneconomic substance transactions.

For purposes of this subsection, the term "nondisclosed noneconomic substance transaction" means any portion of a transaction described in subsection (b)(6) with respect to which the relevant facts affecting the tax treatment are not adequately disclosed in the return nor in a statement attached to the return.

(3) Special rule for amended returns.

In no event shall any amendment or supplement to a return of tax be taken into account for purposes of this subsection if the amendment or

supplement is filed after the earlier of the date the taxpayer is first contacted by the Secretary regarding the examination of the return or such other date as is specified by the Secretary.

* * *

26 C.F.R. § 1.6662-5(g)

* * *

(g) Property with a value or adjusted basis of zero. The value or adjusted basis claimed on a return of any property with a correct value or adjusted basis of zero is considered to be 400 percent or more of the correct amount. There is a gross valuation misstatement with respect to such property, therefore, and the applicable penalty rate is 40 percent

* * *

26 C.F.R. § 301.6231(a)(3)-1

§ 301.6231(a)(3)–1 Partnership items.

(a) In general. For purposes of subtitle F of the Internal Revenue Code of 1954, the following items which are required to be taken into account for the taxable year of a partnership under subtitle A of the Code are more appropriately determined at the partnership level than at the partner level and, therefore, are partnership items:

(1) The partnership aggregate and each partner's share of each of the following:

(i) Items of income, gain, loss, deduction, or credit of the partnership;

(ii) Expenditures by the partnership not deductible in computing its taxable income (for example, charitable contributions);

(iii) Items of the partnership which may be tax preference items under section 57(a) for any partner;

(iv) Income of the partnership exempt from tax;

(v) Partnership liabilities (including determinations with respect to the amount of the liabilities, whether the liabilities are nonrecourse, and changes from the preceding taxable year); and

(vi) Other amounts determinable at the partnership level with respect to partnership assets, investments, transactions and operations necessary to enable the partnership or the partners to determine—

(A) The investment credit determined under section 46(a);

(B) Recapture under section 47 of the investment credit;

(C) Amounts at risk in any activity to which section 465 applies;

(D) The depletion allowance under section 613A with respect to oil and gas wells; and

(E) The application of section 751 (a) and (b);

(2) Guaranteed payments;

(3) Optional adjustments to the basis of partnership property pursuant to an election under section 754 (including necessary preliminary determinations, such as the determination of a transferee partner's basis in a partnership interest); and

(4) Items relating to the following transactions, to the extent that a determination of such items can be made from determinations that the partnership is required to make with respect to an amount, the character of an amount, or the percentage interest of a partner in the partnership, for purposes of the partnership books and records or for purposes of furnishing information to a partner:

(i) Contributions to the partnership;

(ii) Distributions from the partnership; and

(iii) Transactions to which section 707(a) applies (including the application of section 707(b)).

(b) Factors that affect the determination of partnership items. The term "partnership item" includes the accounting practices and the legal and factual determinations that underlie the determination of the amount, timing, and characterization of items of income, credit, gain, loss, deduction, etc. Examples of these determinations are: The partnership's method of accounting, taxable year, and inventory method; whether an election was made by the partnership;

whether partnership property is a capital asset, section 1231 property, or inventory; whether an item is currently deductible or must be capitalized; whether partnership activities have been engaged in with the intent to make a profit for purposes of section 183; and whether the partnership qualifies for the research and development credit under section 30.

(c) Illustrations—(1) In general. This paragraph (c) illustrates the provisions of paragraph (a)(4) of this section. The determinations illustrated in this paragraph (c) that the partnership is required to make are not exhaustive; there may be additional determinations that the partnership is required to make which relate to a transaction listed in paragraph (a)(4) of this section. The critical element is that the partnership needs to make a determination with respect to a matter for the purposes stated; failure by the partnership actually to make a determination (for example, because it does not maintain proper books and records) does not prevent an item from being a partnership item.

(2) Contributions. For purposes of its books and records, or for purposes of furnishing information to a partner, the partnership needs to determine:

(i) The character of the amount received from a partner (for example, whether it is a contribution, a loan, or a repayment of a loan);

(ii) The amount of money contributed by a partner;

(iii) The applicability of the investment company rules of section 721(b) with respect to a contribution; and

(iv) The basis to the partnership of contributed property (including necessary preliminary

determinations, such as the partner's basis in the contributed property).

To the extent that a determination of an item relating to a contribution can be made from these and similar determinations that the partnership is required to make, therefore, that item is a partnership item. To the extent that that determination requires other information, however, that item is not a partnership item. For example, it may be necessary to determine whether contribution of the property causes recapture by the contributing partner of the investment credit under section 47 in certain circumstances in which that determination is irrelevant to the partnership.

(3) Distributions. For purposes of its books and records, or for purposes of furnishing information to a partner, the partnership needs to determine:

(i) The character of the amount transferred to a partner (for example, whether it is a distribution, a loan, or a repayment of a loan);

(ii) The amount of money distributed to a partner;

(iii) The adjusted basis to the partnership of distributed property; and

(iv) The character of partnership property (for example, whether an item is inventory or a capital asset).

To the extent that a determination of an item relating to a distribution can be made from these and similar determinations that the partnership is required to make, therefore, that item is a partnership item. To the extent that that determination requires other information, however, that item is not a partnership item. Such other information would include those factors used in determining the partner's basis for the partnership interest that are not themselves

partnership items, such as the amount that the partner paid to acquire the partnership interest from a transferor partner if that transfer was not covered by an election under section 754.

* * *

26 C.F.R. § 301.6231(a)(5)-1

§ 301.6231(a)(5)–1 Definition of affected item.

(a) In general. The term affected item means any item to the extent such item is affected by a partnership item. It includes items unrelated to the items reflected on the partnership return (for example, an item, such as the threshold for the medical expense deduction under section 213, that varies if there is a change in an individual partner's adjusted gross income).

(b) Basis in a partner's partnership interest. The basis of a partner's partnership interest is an affected item to the extent it is not a partnership item.

(c) At-risk limitation. The application of the at-risk limitation under section 465 to a partner with respect to a loss incurred by a partnership is an affected item to the extent it is not a partnership item.

(d) Passive losses. The application of the passive loss rules under section 469 to a partner with respect to a loss incurred by a partnership is an affected item to the extent it is not a partnership item.

(e) Penalty, addition to tax, or additional amount—(1) In general. The term affected item includes any penalty, addition to tax, or additional amount provided by subchapter A of chapter 68 of the Internal Revenue Code of 1986 to the extent provided in this paragraph (e).

(2) Penalty, addition to tax, or additional amount without floor. If a penalty, addition to tax, or additional amount that does not contain a floor (that is, a threshold amount of underpayment or understatement necessary before the imposition of the penalty, addition to tax, or additional amount) is

imposed on a partner as the result of an adjustment to a partnership item, the term affected item shall include the penalty, addition to tax, or additional amount computed with reference to the portion of the underpayment that is attributable to the partnership item adjustment(s) to which the penalty, addition to tax, or additional amount applies.

(3) Penalty, addition to tax, or additional amount containing floor—(i) Floor exceeded prior to adjustment. If a partner would have been subject to a penalty, addition to tax, or additional amount that contains a floor in the absence of an adjustment to a partnership item (that is, the partner's understatement or underpayment exceeded the floor even without an adjustment to a partnership item) the term affected item shall include only the portion of the penalty, addition to tax, or additional amount computed with reference to the partnership item (or affected item) adjustments.

(ii) Floor not exceeded prior to adjustment. In the case of a penalty, addition to tax, or additional amount that contains a floor, if the taxpayer's understatement or underpayment does not exceed the floor prior to an adjustment to a partnership item but does so after such adjustment, the term affected item shall include the penalty, addition to tax, or additional amount computed with reference to the entire underpayment or understatement to which the penalty, addition to tax, or additional amount applies.

(4) Examples. The provisions of this paragraph (e) may be illustrated by the following examples:

Example 1. A, a partner of P, had an aggregate underpayment of $1,000 of which $100 is attributable to an adjustment to partnership items. A is negligent in

reporting the partnership items. The accuracy-related penalty under section 6662 for negligence computed with reference to the $100 underpayment attributable to the partnership item adjustments is an affected item.

Example 2. B, a partner of P, understated B's income tax liability attributable to nonpartnership items by $6,000. An adjustment to a partnership item resulting from a partnership proceeding increased B's income tax by an additional $2,000. Prior to the adjustment, B would have been subject to the accuracy-related penalty under section 6662 for a substantial understatement of income tax with respect to the $6,000 understatement attributable to nonpartnership items. The portion of the accuracy-related penalty under section 6662 computed with reference to the $2,000 understatement attributable to partnership items to which the accuracy-related penalty applies is an affected item. The portion of the accuracy-related penalty under section 6662 computed with reference to the $6,000 pre-existing understatement is not an affected item.

Example 3. C, a partner in partnership P, understated C's income tax liability attributable to nonpartnership items by $4,000. As a result of an adjustment to partnership items, that understatement is increased to $10,000. Prior to the adjustment, C would not have been subject to the accuracy-related penalty under section 6662 for a substantial understatement of income tax. The accuracy-related penalty under section 6662 computed with reference to

the entire $10,000 understatement to which the accuracy-related penalty applies is an affected item.

* * *

26 C.F.R. § 301.6231(a)(6)-1

§ 301.6231(a)(6)–1 Computational adjustments.

(a) Changes in a partner's tax liability—(1) In general. A change in the tax liability of a partner to properly reflect the treatment of a partnership item under subchapter C of chapter 63 of the Internal Revenue Code is made through a computational adjustment. A computational adjustment includes a change in tax liability that reflects a change in an affected item where that change is necessary to properly reflect the treatment of a partnership item, or any penalty, addition to tax, or additional amount that relates to an adjustment to a partnership item. However, if a change in a partner's tax liability cannot be made without making one or more partner-level determinations, that portion of the change in tax liability attributable to the partner-level determinations shall be made under the deficiency procedures (as described in subchapter B of chapter 63 of the Internal Revenue Code), except for any penalty, addition to tax, or additional amount that relates to an adjustment to a partnership item.

(2) Affected items that do not require partner-level determinations. Changes in a partner's tax liability with respect to affected items that do not require partner-level determinations (such as the threshold amount of medical deductions under section 213 that changes as the result of determinations made at the partnership level) are computational adjustments that are directly assessed. When making computational adjustments, the Internal Revenue Service may assume that amounts the partner reported on the partner's individual return include all amounts

reported to the partner by the partnership (on the Schedule K–1s attached to the partnership's original return), absent contrary notice to the Internal Revenue Service (for example, a "Notice of Inconsistent Treatment" pursuant to § 301.6222(a)–2(c)). Such an assumption by the Internal Revenue Service does not constitute a partner-level determination. Moreover, substituting redetermined partnership items for the partner's previously reported partnership items (including partnership items included in carryover amounts) does not constitute a partner-level determination where the Internal Revenue Service otherwise accepts, for the sole purpose of determining the computational adjustment, all nonpartnership items (including, for example, nonpartnership item components of carryover amounts) as reported.

(3) Affected items that require partner-level determinations. Changes in a partner's tax liability with respect to affected items that require partner-level determinations (such as a partner's at-risk amount to the extent it depends upon the source from which the partner obtained the funds that the partner contributed to the partnership) are computational adjustments that are subject to the deficiency procedures. Notwithstanding the preceding sentence, any penalty, addition to tax, or additional amount that relates to an adjustment to a partnership item is not subject to the deficiency procedures, but rather may be directly assessed as part of the computational adjustment that is made following the partnership proceeding, based on determinations in that

proceeding, regardless of whether any partner-level determinations may be required.

* * *

REPLY BRIEF

RECORD
AND
BRIEFS

No. 12-562

In the Supreme Court of the United States

UNITED STATES OF AMERICA, PETITIONER

v.

GARY WOODS, AS TAX MATTERS PARTNER OF TESORO DRIVE PARTNERS, ET AL.

ON WRIT OF CERTIORARI
TO THE UNITED STATES COURT OF APPEALS
FOR THE FIFTH CIRCUIT

REPLY BRIEF FOR THE UNITED STATES

DONALD B. VERRILLI, JR.
Solicitor General
Counsel of Record
Department of Justice
Washington, D.C. 20530-0001
SupremeCtBriefs@usdoj.gov
(202) 514-2217

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REPLY BRIEF FOR THE UNITED STATES

On both the jurisdictional and merits questions, respondent presents arguments that cannot be reconciled with the statutes Congress wrote. He first contends that, in a partnership-level proceeding under 26 U.S.C. 6226(f), a district court lacks jurisdiction to determine the applicability of any penalty whose imposition depends on a further "partner-level inquiry." Br. 27. But such an inquiry is virtually always required before any penalty can be imposed. Respondent's approach would therefore negate Congress's grant of authority to courts in partnership-level proceedings to determine the applicability of penalties. The only understanding of the jurisdictional provision that gives it practical significance is the one advanced by the government: that a district court must determine whether a partnership-level error, if carried over

onto an individual partner's return, could trigger a penalty. Under that reading, the district court had jurisdiction to determine the applicability of the basis-overstatement penalty in this case.

On the merits, respondent principally argues that the penalty for overstating the "adjusted basis of any property," 26 U.S.C. 6662(e)(1)(A), is implicitly limited to "fact-based basis errors" (Br. 39), a concept that excludes misstatements produced through the unlawful manipulation of rules governing basis computation. None of the ten courts of appeals to address the issue has adopted that view; respondent did not urge that construction below; and nothing in the text, structure, or purposes of the relevant provisions supports respondent's position.

A. The District Court Had Jurisdiction Under Section 6226(f) Because The Basis-Overstatement Penalty "Relates To" The Court's Adjustments To Partnership Items

1. A district court in a partnership-level proceeding has jurisdiction to determine "the applicability of any penalty * * * which relates to an adjustment to a partnership item." 26 U.S.C. 6226(f). Respondent does not dispute that any basis-overstatement penalty ultimately imposed on any of the partners here will be imposed as a consequence of the district court's "adjustment to a partnership item" (*i.e.*, the court's determination that the two partnerships and their transactions were legal shams). Respondent nevertheless maintains that the penalty would not "relate[] to" that adjustment. Respondent identifies no plausible understanding of the term "relates to" that would exclude a penalty imposed specifically because an ad-

justment to a partnership item rendered the taxpayer's individual return inaccurate.

Respondent emphasizes (Br. 25) that the imposition of a basis-overstatement penalty on any individual partner will require a determination that the partner's own return overstated his outside basis in partnership assets. Respondent argues that "[b]ecause 'outside basis is an affected item, not a partnership item,' the asserted penalty 'relates to an adjustment of an affected item, not a partnership item.'" *Ibid.* (quoting *Jade Trading, LLC* v. *United States*, 598 F.3d 1372, 1380 (Fed. Cir. 2010)). The unstated premise of respondent's argument is that a particular penalty can "relate[] to" only one adjustment. Nothing in the Taxpayer Relief Act supports that proposition, which is contrary to the usual understanding that the term "relates to" encompasses a broad range of connections. See, *e.g.*, *Morales* v. *Trans World Airlines*, 504 U.S. 374, 383-384 (1992); Gov't Br. 31-32. Where, as here, a penalty relates to both an affected-item adjustment and a partnership-item adjustment, the plain text of Section 6226(f) gives a court jurisdiction to determine the applicability of the penalty in a partnership-level proceeding.

Respondent asserts that the government's approach would render the Taxpayer Relief Act's jurisdictional limitation "meaningless" because it would allow the district court in a partnership-level proceeding to consider all penalties that relate to adjustments to affected items. Br. 29. That argument reflects a misunderstanding of the government's position. The government does not contend that the courts below were authorized to determine the applicability of the basis-overstatement penalty *because* that penalty

"relates to" an adjustment to an affected item. Rather, the government's view is that (a) a particular penalty may "relate[] to" more than one adjustment, and (b) so long as the necessary relationship to a partnership-item adjustment exists, the fact that the penalty *also* "relates to" an adjustment to an affected item does not prevent the court in a partnership-level proceeding from determining its applicability.[1]

Respondent acknowledges that, under his interpretation, Section 6226(f) would not provide jurisdiction to determine the applicability of any penalty requiring a further "partner-level inquiry," "whether or not the penalty has a connection to a partnership item." Br. 27. But the ultimate imposition of virtually every penalty (including all of the accuracy-related penalties that would naturally follow from adjustments to partnership items) requires a partner-level inquiry, if only to verify that errors on the partnership return were carried forward to the partner's individual return. The express statutory authorization for the court in a partnership-level proceeding to determine the "applicability" of penalties would be a practical nullity if the need for further partner-level inquires precluded the court from acting.

Respondent offers no response to this basic flaw in his position, even though the government's opening

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[1] Contrary to respondent's contention (Br. 28), a penalty can "relate to" an adjustment to an affected item without relating to an adjustment to a partnership item. For example, an adjustment to a partner's outside basis (an affected item) might stem from his misstatement of the price he had paid a prior partner for the partnership interest. 26 U.S.C. 742. In that case, the court in a partnership-level proceeding would lack jurisdiction to determine the applicability of the basis-overstatement penalty.

brief repeatedly highlights the problem. See Gov't Br. 22, 28, 35-37. Indeed, he embraces it, seeking relief under his newly minted jurisdictional theory from every penalty the district court found applicable. See Br. 31 n.4. That belated request confirms the extraordinary breadth of his argument.[2]

2. Respondent emphasizes what he views as an incongruity in the government's interpretation of Section 6226(f): that a district court has jurisdiction to determine the applicability of the basis-overstatement penalty for a taxpayer's misrepresentation of outside basis, but lacks jurisdiction to determine the taxpayer's outside basis itself. See Br. 21-24. Respondent contends that a court can determine the applicability of the penalty only if it has "jurisdiction to determine that the partners actually misrepresented their outside basis." Br. 21.

Respondent misunderstands the district court's task in determining "the applicability of any penalty" in a partnership-level proceeding. As discussed, every accuracy-related penalty that relates to a partnership-item adjustment—whether resting on a misrepresentation of outside basis, inside basis, income, or any other item—turns on a partner-level inquiry that a court in a partnership-level proceeding lacks jurisdic-

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[2] Because respondent voluntarily dismissed his cross-appeal in the court of appeals, he cannot obtain relief in this Court from the district court's adverse rulings with respect to the applicability of other penalties (see Pet. App. 7a-13a). See *Greenlaw* v. *United States*, 554 U.S. 237, 244-245 (2008). Vacating those aspects of the district court's judgment would also "alter the Court of Appeals' judgment" affirming the district court, "which is impermissible in the absence of a cross-petition from respondent." *Genesis Healthcare Corp.* v. *Symczyk*, 133 S. Ct. 1523, 1529 (2013); Pet. App. 2a.

tion to conduct. For that reason, the statute requires "partner level defenses" to penalties to be raised only in subsequent partner-level proceedings. 26 U.S.C. 6230(c)(4).[3] Because of that bifurcated structure, the requirement that a district court determine the "applicability" of penalties in partnership-level proceedings can only mean that the court must determine whether any error at the partnership level, *if* carried over to an individual partner's return, could trigger a penalty.

Respondent's counterexample (Br. 27) of what he concedes to be a permissible partnership-level penalty determination—for a misrepresentation of a partnership's *inside* basis in a flea-market painting—simply illustrates that point. Because the partnership itself cannot be liable for any basis-overstatement penalty, the mere fact that the partnership misreported its basis in the painting does not mean that a penalty will ultimately be imposed. The determination whether any individual partner is subject to the penalty will turn on a number of subsidiary, partner-specific questions, such as whether the partner actually gave effect to the incorrect basis figure on her return and whether doing so led her to report less than her correct

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[3] Amici assert that it is "strained" to call individualized objections to the imposition of a penalty, such as a contention that the taxpayer does not meet the applicable dollar or percentage threshold for the penalty, partner-level "defenses." New Millennium Trading Amicus Br. 17. Under the statutory scheme, however, those objections arise as "defenses" because partners assert them in refund proceedings only after the IRS determines that the requirements for a penalty are met and assesses it. A Treasury regulation defines such objections as "defenses," see 26 C.F.R. 301.6221-1(d), and those regulations are entitled to *Chevron* deference.

income. Like a partner's outside basis, those determinations cannot be made at the partnership level and will be resolved only after the district court has determined "the applicability of any penalty which relates to an adjustment to a partnership item," 26 U.S.C. 6226(f).

Respondent's amici propose a somewhat different test, arguing that the court in a partnership-level proceeding has jurisdiction to determine the applicability of a penalty if its imposition on any individual partner would require the IRS to make only "purely mathematical" changes to individual returns. New Millennium Trading Amicus Br. 18. As an example of a situation in which the applicability of penalties could be determined in partnership-level proceedings, amici refer to "the common situation where the IRS adjusts the income or loss reported by a partnership." *Id.* at 19. Amici offer no principled basis for distinguishing that scenario from the situation presented here.

If a partnership return understated the partnership's net income, the ultimate imposition of the income-tax understatement penalty (26 U.S.C. 6662(b)(2)) on any individual partner would depend on, *inter alia*, whether the partner carried the error onto her individual return in calculating her tax liability, and whether any underpayment of tax resulted. In a particular case, either of those prerequisites to the imposition of penalties might be satisfied for "some, but not all, of the partners." New Millennium Trading Amicus Br. 20. If any individual partner asserted that he had "reasonable cause" for the error on his own return, it would also be necessary to make the (non-mathematical) determination whether such "reasonable cause" existed before the penalty could be im-

posed. See 26 U.S.C. 6664(c)(1). None of those determinations could be made in the partnership-level proceeding itself. Indeed, amici concede that the "applicability" of a penalty for partnership negligence may be determined at the partnership level "because no partner level determinations need be made to establish the factual support for that penalty," even though amici recognize that "partner level defenses" to the penalties may remain to be resolved in partner-level proceedings. New Millennium Trading Amicus Br. 19 & n.7.

Once that understanding of the term "applicability" is accepted, there is no sound reason to question the district court's jurisdiction to determine the "applicability" of the basis-overstatement penalty here. The court had jurisdiction to determine whether, *if* the partners computed their outside bases on the assumption that the COBRA partnerships and transactions had economic substance, the basis-overstatement penalty could apply. That this question is suitable for resolution in partnership-level proceedings is borne out by the fact that respondent has devoted approximately 25 pages of his brief to the issue (see Br. 31-55), without either relying on partner-specific information or suggesting that the unavailability of such information will hinder the Court's ability to decide the question on which it granted certiorari.

Contrary to respondent's contention, the government's approach does not reflect a "penalty first—verdict afterwards" scheme (Br. 23-24) (citation omitted), because no penalty is imposed as part of the partnership-level proceedings. After those proceedings have been completed, the IRS will adjust the partners' returns as warranted and determine the

resulting deficiencies. 26 U.S.C. 6230(a)(2)(A)(i). It will then assess the additional tax and the corresponding penalties, and the individual partners will have the opportunity to raise any partner-level defenses to the penalties through refund proceedings. See 26 U.S.C. 6230(c)(1)(C) and (4).[4]

To relieve the burden on the IRS and the Tax Court, Congress made the potentially time-consuming deficiency procedures (which may include Tax Court review) inapplicable to "penalties * * * that relate to adjustments to partnership items." 26 U.S.C. 6230(a)(2)(A)(i); see Gov't Br. 37-38; H.R. Rep. No. 148, 105th Cong., 1st Sess. 594 (1997). As a prerequisite to that streamlined process, however, the IRS must first make a threshold finding in partnership-level proceedings, subject to judicial review, that a penalty is "applicable," *i.e.*, that a partnership-level error could trigger the penalty at the partner level. 26 U.S.C. 6221, 6226(f). Respondent never acknowledges this basic objective of the jurisdictional provision or explains how his reading of the statute comports with it.

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[4] Respondent suggests (Br. 15, 30) that the IRS FPAAs at issue in this case actually "imposed" the basis-overstatement penalty on the individual partners. That is incorrect. Rather, with regard to penalties, the FPAAs stated that use of the basis figures reflected on the partnership return would constitute a gross valuation misstatement, and that "a 40 percent penalty shall be imposed on the portion of any underpayment attributable to the gross valuation misstatement." J.A. 96, 150. The FPAAs did not analyze whether the partners' S corporations had actually used the inflated basis figures on their own returns, whether any underpayment of tax had resulted, or what the amounts of any applicable penalties might be.

B. When A Taxpayer Overstates His Basis In Property By Giving Legal Effect To Sham Transactions, The Overstatement Penalty Can Apply

1. A taxpayer who uses sham transactions to illegally claim a high basis in assets overstates "the adjusted basis of any property"

Respondent urges for the first time an interpretation of Section 6662(e)(1)(A) that none of the ten courts of appeals to consider the issue has adopted: that the basis-overstatement penalty applies only to "fact-based basis errors," not to "legal errors" arising from misapplication of the rules governing the computation of basis. Br. 31-46. That argument lacks merit.

a. i. Respondent contends that the overstatement penalty applies only where the basis overstatement rests on an error of "valuation," *i.e.*, "a fact-based assessment of the monetary worth (or value) of something." Br. 33-34, 37. That is not what Section 6662 says. The statute imposes a penalty where "the value of any property (*or* the adjusted basis of any property) claimed on any [income tax] return * * * is 200 percent or more of the amount determined to be the correct amount of such valuation *or* adjusted basis (*as the case may be*)." 26 U.S.C. 6662(e)(1)(A) (emphases added). Congress's use of the disjunctive "or," and its inclusion of the phrase "as the case may be," indicate beyond serious doubt that the penalty can be imposed when the taxpayer's return overstates *either* the "value" of property *or* the "adjusted basis" of property, and an underpayment of tax results.

Respondent's interpretation of Section 6662(e)(1)(A) relies substantially on the presence of parentheses around the phrase "or the adjusted basis of any property." He argues that the "parenthetical

construction signals that the item inside the parenthesis is meant to illustrate or explain what is outside the parentheses." Br. 38. But while that is true in many contexts, it is surely not true here, where the parenthetical clause begins with the word "or." That disjunctive does not introduce a clarification or illustration; it points to an alternative way to trigger the penalty. Cf. *Chickasaw Nation* v. *United States*, 534 U.S. 84, 89 (2001) (parenthetical clause introduced by "including"). As this Court has explained, "[c]anons of construction ordinarily suggest that terms connected by a disjunctive be given separate meanings, unless the context dictates otherwise." *Reiter* v. *Sonotone Corp.*, 442 U.S. 330, 339 (1979).[5]

Here, no special contextual factor supports an atypical reading of "or." The term "basis" could not be read as an example or synonym of "value," because "basis" is generally defined as "the cost of * * * property" to the taxpayer. 26 U.S.C. 1012(a). A taxpayer's basis in her house does not increase because the housing market picks up. And in the immediately following subparagraph of Section 6662(e), which identifies another set of circumstances in which the overstatement penalty is triggered, two disjunctive parenthetical phrases appear, neither of which is illustrative. See 26 U.S.C. 6662(e)(1)(B)(i) ("the price for any property or services (or for the use of proper-

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[5] As respondent acknowledges (Br. 38), moreover, the predecessor to the current Section 6662(e)(1)(A) did not include parentheses. The legislative history of the current provision stated that the new penalty was "generally the same as the valuation overstatement penalty provided under present law with five [irrelevant] modifications." H.R. Conf. Rep. No. 386, 101st Cong., 1st Sess. 653 (1989).

ty) claimed on any such return * * * is 200 percent or more (or 50 percent or less) of the amount determined * * * to be the correct amount of such price"). Moreover, any conceivable ambiguity raised by the parentheses would be resolved by the repetition of the term "adjusted basis" outside of the parentheses at the end of the sentence and, most clearly, by the phrase "as the case may be." That phrase indicates that the penalty targets two categories of "case[s]": overstatements of value and overstatements of adjusted basis.

The only actual language in the operative text that respondent cites for support is the term "correct amount." Br. 34. Both "value" and "adjusted basis," however, are numerical "amounts," and there is nothing anomalous about using the term "amount" to refer to a sum whose calculation depends in part on the application of legal rules. See, *e.g.*, 26 U.S.C. 6662(d)(2)(A) (referring to "the amount of the tax required to be shown on the return for the taxable year"). Respondent also observes that the defined term is "valuation misstatement." Br. 34. But while ambiguities in a statutory definition may be resolved by reference to usual understandings of the defined term, Section 6662(e)(1)(A) *unambiguously* defines "valuation misstatement" to include specified overstatements of adjusted basis. That unambiguous definition controls. See *Burgess* v. *United States*, 553 U.S. 124, 129-130 (2008).

ii. Contrary to respondent's apparent assumption, the terms "basis," "value," and "valuation" do not connote purely "fact-based" concepts. The Internal Revenue Code's definition of "basis" makes clear that the formula for calculating it, even before making

adjustments, depends on the application of legal rules, including specialized rules for "partners and partnerships." See, *e.g.*, 26 U.S.C. 1012(a). In enacting Section 6662(e)(1)(A), Congress thus legislated against a well-settled understanding that basis is the product of both legal and factual determinations.

The same is true of "value" or "valuation." As any student of accounting knows, valuation depends in part on the application of methodological rules and principles, and none of the definitions that respondent cites (Br. 34 n.6) suggests that valuation is exclusively "fact-based." Respondent is wrong in contending that the "Tax Court has a longstanding practice of treating valuation issues as matters of *fact*, rather than questions of law." Br. 35. The Tax Court has explained, for example, that "three approaches are used to determine the fair market value of property" for tax purposes, and that "[t]he question of which approach to apply in a case is a question of law." *Chapman Glen Ltd.* v. *Commissioner*, Nos. 29527-07L, 27479-09, 2013 WL 2319282, at *17 (May 28, 2013) (citing *Powers* v. *Commissioner*, 312 U.S. 259, 260 (1941)). Numerous special legal rules, moreover, apply to the valuation of particular types of property. See, *e.g.*, 26 U.S.C. 170(f)(4) (remainder interest in real property donated to charity). Because all property valuations include such threshold legal determinations, "[v]aluation is a mixed question of law and fact." *Whitehouse Hotel Ltd. P'ship* v. *Commissioner*, 615 F.3d 321, 333 (5th Cir. 2010) (citation omitted).

iii. Respondent's view that Section 6662 applies only to "fact-based basis errors" also ignores the statute's reference to overstatements of *adjusted* basis. Even after a taxpayer's basis in particular property

has been determined, see 26 U.S.C. 1012(a), the calculation of "adjusted basis" can entail the application of additional legal rules governing issues like depreciation and amortization. See 26 U.S.C. 1011(a), 1016. For example, the Internal Revenue Code specifies different rates of depreciation for different types of property. See 26 U.S.C. 168(c). The word "adjusted" in Section 6662(e)(1)(A) makes clear that the penalty can be imposed when a taxpayer correctly determines initial basis (see 26 U.S.C. 1012) but miscalculates the applicable adjustments. That choice would be inexplicable if Congress had intended to confine the penalty to underpayments resulting from "fact-based basis errors."

b. Even if the plain text of Section 6662 did not foreclose respondent's argument, the Treasury regulation concerning the overstatement penalty would. The regulation states, as an example of the overstatement penalty's application, that a corporation commits a "valuation misstatement" if it fails properly to take into account depreciation in computing its adjusted basis in an asset. 26 C.F.R. 1.6662-5(d), ex. 3. That regulation, which is entitled to judicial deference, see Gov't Br. 43, makes clear that basis overstatements can result from legal errors.

c. Respondent contends that, if the overstatement penalty applied to misstatements arising from legal errors, Congress would have enacted a defense for taxpayers who make reasonable legal mistakes in computing their bases in property. See Br. 41. But the Code provides for exactly such a defense by prohibiting imposition of a penalty "if it is shown that there was a reasonable cause" for the underpayment and "the taxpayer acted in good faith." 26 U.S.C.

6664(c)(1). That includes "an honest misunderstanding of fact *or* law." 26 C.F.R. 1.6664-4(b) and (c) (emphasis added).

Respondent acknowledges that Section 6664(c)(1) makes "a 'reasonable cause' defense available to most of the § 6662 penalties," but emphasizes that this "defense is not *specific* to legal mistakes." Br. 41 n.8. Respondent contrasts Section 6664(c)(1) with other provisions that focus more specifically on underpayments resulting from reasonable but wrong views of the law. See Br. 41. But the fact that Congress sometimes focuses on legal errors does not detract from the significance of Section 6664(c)(1), which applies generally to penalties imposed under Section 6662, and which by its terms applies to both legal and factual mistakes. The more natural inference from that provision is that Congress recognized that Section 6662 penalties can result from either sort of error. Section 6664(c)(1) also suggests that Congress perceived a need for a catchall "reasonable cause"/"good faith" defense that would encompass legal errors. Such a catchall provision would be superfluous, however, if Congress had enacted a separate "specifically legal defense" (Resp. Br. 42) for every penalty provision that might be triggered by legal mistakes.

Nor is there anything objectionable about the fact that basis overstatements arising from sham transactions will nearly always trigger the 40% penalty for gross misstatements. See Resp. Br. 42-43. The most egregious misconduct—engaging in phony transactions to create an artificial basis—warrants the most severe sanction.

d. None of the legislative-history materials on which respondent relies (Br. 35-36) even hints that the

penalty at issue here does not apply to misrepresentations of basis or value that arise from legally erroneous computations. The statement that "valuation issues *frequently* involve difficult questions of fact," H.R. Rep. No. 201, 97th Cong., 1st Sess. 243 (1989) (emphasis added), implies that they *can* involve other sorts of issues, consistent with the courts' view that valuation issues raise mixed questions of law and fact. And the 1989 testimony by a member of an accountants' organization—which respondent attributes to "Congress" (Br. 36)—does little more than explain that valuation can be difficult. *Review of the Civil Penalty Provisions Contained in the Internal Revenue Code: Hearings on H.R. 2528 Before the Subcomm. on Oversight of the House Comm. on Ways and Means*, 101st Cong., 1st Sess. 114 (1989). Particularly given the fact that the witness "wholeheartedly recommend[ed] repeal of the[] valuation penalty sections," *ibid.*, that testimony sheds no meaningful light on the meaning of the statutory language that Congress enacted and subsequently retained.

e. Ultimately, any attempt to limit the valuation-misstatement penalty to "fact-based" errors would lead to impossible conceptual questions and consequences that Congress could not have intended. As discussed, property valuation begins with a threshold legal determination of which valuation method to use. See, *e.g.*, *Whitehouse Hotel*, 615 F.3d at 333. Taken to its logical conclusion, respondent's theory would permit a taxpayer who misvalued property to avoid the overstatement penalty merely by claiming that he had used a legally erroneous methodology rather than committing a "fact-based" error. And even if respondent's theory were not embraced to that extent,

shielding basis misstatements premised on legal errors from the penalty would immunize a wide array of misstatements, such as use of the wrong depreciation rate. See Resp. Br. 42.

Nor is there any sound reason to create a special exemption for the type of legal error at issue here. It is well-settled that a taxpayer may not compute his basis in an asset using transactions that lacked economic substance. That is a necessary principle of tax law because the complexity of the rules governing income-tax computation creates opportunities for manipulation by sophisticated parties. In attempting to characterize this error as different in kind from other basis errors, respondent describes the district court as holding that "the property should be deemed not to exist." Br. 32-33. In fact, the court did not cast doubt on the existence of the sold property (*i.e.*, the assets distributed upon dissolution of the partnerships). Rather, it held that because the partnerships and their transactions lacked economic substance, the partners could not use the rules normally applicable to those types of transactions in computing the S corporations' basis in the distributed property. See Pet. App. 20a-21a. To the extent they improperly relied on those rules to make that computation, the partners misstated "the adjusted basis of * * * property."

2. Any underpayment of tax resulting from COBRA was "attributable to" a basis overstatement

a. Respondent devotes only five pages of his merits brief (46-51) to the rationale on which the court of appeals ruled in his favor: that when a taxpayer uses sham transactions to claim an unlawfully high basis figure on his tax return, any resulting underpayment of tax is not "attributable to" a basis overstatement.

Respondent's abbreviated defense of that holding rests on the court of appeals' view that a determination that a basis-inflating transaction lacks economic substance is an "independent legal ground" for disallowing any resulting tax deduction. Br. 46.

As the government's opening brief explains (at 46-48), that position is erroneous. The existence of an independent ground to disallow a deduction does not break the causal link between the basis overstatement and the underpayment of tax. And even if it did, the economic-substance determination here was not independent of the basis overstatement. The sham nature of the partnership transactions was the reason that the basis figures were overstated, not a separate legal defect. Indeed, if Woods and McCombs had merely purchased and sold options of lesser value as part of the COBRA scheme, and had ultimately claimed a smaller basis in the assets, they would have paid more tax than they did. Any underpayment resulting from COBRA was therefore "attributable to," because it was caused by, a basis overstatement.

Respondent observes that, in some factual scenarios, the government's position "would force a court to decide valuation issues for the sole purpose of imposing a valuation misstatement penalty," even though the valuation will have no ultimate effect on the amount of tax owed. Br. 47 (citation omitted). That could be true, for example, when a deduction that is alleged to rest on a misstatement of value or basis is wholly disallowed on an independent ground that does not give rise to penalties. See Gov't Br. 44-45 (discussing *Todd* v. *Commissioner*, 862 F.2d 540 (5th Cir. 1988)). There is no reason to suppose, however, that conducting such additional inquiries to determine

whether penalties should be imposed is contrary to Congress's intent. Ascertaining a taxpayer's liability for penalties will often require additional inquiries (*e.g.*, whether there was "reasonable cause" for all or part of an underpayment, and whether "the taxpayer acted in good faith," 26 U.S.C. 6664(c)(1)) beyond those needed to determine whether an underpayment of tax exists. And the alternative to that approach—*i.e.*, treating the existence of an *additional* ground for disallowing a claimed deduction as a reason to exempt the taxpayer from penalties to which he would otherwise be subject—creates anomalous and unfair results. See Gov't Br. 46.

In any event, the present case does not involve valuation issues whose relevance is limited to the imposition of penalties. The district court's determination that the relevant partnerships and transactions were shams, which means that the correct basis in the pertinent assets is zero, is integral to the determination of Woods's and McCombs's liability for additional taxes owed.

b. Respondent also relies on the post-enactment discussion of the overstatement penalty in the *Blue Book*. Br. 48-51; see Gov't Br. 5-7. Although that document can be useful for construing ambiguous provisions of the Code, there is no ambiguity here. In any event, respondent does not address the explanation in our opening brief that the *Blue Book*'s formula was designed for two *unrelated* deductions, not two alternative grounds for disallowing the *same* deduction. See Gov't Br. 45-46.

In a case like this one, moreover, the sham determination is not an alternative "adjustment" from the corrected basis; it is the very reason that the basis

was overstated. Although respondent correctly observes that "[t]he district court treated the operation of the economic substance doctrine as fatal *in and of itself* to the reported losses" (Br. 49), he does not acknowledge that in an abusive tax shelter like COBRA, the "basis misstatement [is] the engine of, the vehicle behind the sham transaction." *Bemont Invs. LLC* v. *United States*, 679 F.3d 339, 353 (5th Cir. 2012) (Prado, J., concurring).[6]

3. Neither the 2010 statutory amendment nor any applicable canon of construction supports respondent's constricted interpretation of the basis-overstatement penalty

a. Although the basis-overstatement penalty was first enacted in 1981, and amended and recodified in 1989, respondent argues that this Court should inter-

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[6] Contrary to respondent's characterization (Br. 50-51), the government claims *Chevron* deference on this question only insofar as Treasury regulations refute the court of appeals' holding that the total disallowance of a deduction categorically precludes the overstatement penalty. See Gov't Br. 43.

Amici contend that non-binding litigation guidelines issued in 1992 and 2011 by the IRS for its attorneys support the court of appeals' holding. See New Millennium Trading Amicus Br. 25-29. In fact, those guidelines consistently maintained that the overstatement penalty applies in cases like this one. See Litigation Guideline Memorandum, IRS LGM TL-68, 1992 WL 1355877 (Aug. 12, 1992); Chief Counsel Notice, IRS CC-2012-001, at 4 (Oct. 5, 2011), http://www.irs.gov/pub/irs-ccdm/cc-012-001.pdf. Relying on Tax Court decisions that have distinguished between pre- and post-trial concessions, the 1992 memorandum recommended that attorneys not seek the penalty when the taxpayer has conceded a truly alternative ground for disallowance prior to trial. The 2011 memorandum, however, instructed attorneys to address such concessions "on a case-by-case basis."

pret Section 6662(e)(1)(A) in light of a 2010 amendment to Section 6662. See Br. 44-46, 53-55. That amendment imposes a penalty of 40% of the underpayment of tax attributable to a transaction deemed to lack economic substance that was not disclosed to the IRS. See 26 U.S.C. 6662(b)(6) and (i). Respondent variously contends that the amendment either changes the meaning of the overstatement penalty or "sheds light" on its original meaning, on the theory that "[i]f Congress had adopted the broad-based 'basis-overstatement penalty' advanced by the government, there would have been no need for Congress to adopt this new penalty." Br. 45.

Those arguments lack merit. The 2010 amendment does not apply to this case, and it did not alter the text of either Section 6662(b)(3) (which establishes the penalty for underpayments of tax resulting from substantial valuation misstatements) or Section 6662(e)(1)(A) (which defines "substantial valuation misstatement" to include overstatements of adjusted basis). There is also no logical inconsistency between the government's reading of Section 6662(e)(1)(A) and Congress's decision to enact the 2010 amendment. Like the circles of a Venn diagram, the two penalties overlap, but each applies to some conduct to which the other does not. The new penalty applies to all sham transactions, not only those that result in an overstatement of basis. The basis-overstatement penalty is not limited to overstatements of adjusted basis that result from sham transactions.

The existence of some overlap between the two penalties does not render either superfluous. There is also substantial overlap between, for example, the overstatement penalty and the negligence penalty or

the income-tax understatement penalty. See 26 U.S.C. 6662(b)(1) and (2). Congress has enacted various anti-stacking provisions to prevent the cumulative imposition of two distinct penalties for the same underpayment of tax. See 26 U.S.C. 6662(b) (last two sentences), 6662A(e), 6701(f)(2) and (3); see also 26 C.F.R. 1.6662-2(c). Those provisions limit taxpayers' potential exposure to penalties. And by demonstrating that Congress anticipated cases in which particular transactions or underpayments would implicate more than one penalty provision, the anti-stacking provisions refute respondent's contention that the enactment of new Section 6662(b)(6) and (i) is a reason to hold Section 6662(e)(1)(A) inapplicable. Congress, moreover, had ample reason to establish overlapping penalty coverage for schemes like COBRA given the longstanding outlier interpretations of the overstatement penalty adopted by the Fifth and Ninth Circuits. See Pet. 27-29.

Although the two penalties are harmonious under the government's reading, respondent's interpretation would leave a large gap in their coverage. Because respondent maintains that "Congress did not intend to reach legal errors with the valuation misstatement penalty" (Br. 41), his interpretation would shield from both penalties all "legal" basis errors—even for basis figures far exceeding the threshold for a gross valuation misstatement—other than those resulting from application of the economic-substance doctrine. Adoption of that view would produce far more serious anomalies than concluding that both penalties apply in certain tax-shelter cases.[7]

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[7] Respondent is similarly wrong in pointing to (Br. 54-55) the 2004 enactment of certain penalties relating to reportable transac-

b. Respondent finally contends (Br. 51-52) that Section 6662 is sufficiently ambiguous that it should be construed not to apply to schemes in which taxpayers engage in sham transactions with the specific purpose of claiming an unlawfully high basis in an asset. Although ambiguous Internal Revenue Code penalties should be construed in favor of the taxpayer, see *Commissioner* v. *Acker*, 361 U.S. 87, 91 (1959), at least where the "penalty can[not] be easily avoided," *Fulman* v. *United States*, 434 U.S. 528, 533 n.8 (1978), no ambiguity exists here.

Woods and McCombs engaged in a series of sham transactions to create the illusion that their S corporations' basis in assets distributed by the partnerships was $45 million, even though they expended only a tiny fraction of that amount in conducting the transactions. Any resulting underpayments were plainly "attributable to" an overstatement of "the adjusted basis of * * * property," and there is no plausible reason why Congress would have intended to exempt such egregious misconduct from the penalty. Subjecting those who employ sophisticated schemes like COBRA to the same penalty that applies to ordinary taxpayers is the most appropriate way to "ensure that the tax laws are not abused." Resp. Br. 51.

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tions. Contrary to a suggestion in an internal IRS memorandum cited by respondent, the IRS does not take the position that both the Section 6662A penalty and the basis-overstatement penalty can cumulatively be imposed for the same error—an interpretation foreclosed by Sections 6662(b) and 6662A(e)(2)(B). And the Section 6707A penalty that respondent cites is capped at specific dollar figures.

* * * * *

For the foregoing reasons and those stated in our opening brief, the judgment of the court of appeals should be reversed.

Respectfully submitted.

DONALD B. VERRILLI, JR.
Solicitor General

AUGUST 2013

AMICUS CURIAE BRIEF

RECORD
AND
BRIEFS

No. 12-562

Supreme Court, U.S.
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In The

Supreme Court of the United States

UNITED STATES,

Petitioner,

vs.

GARY WOODS, as Tax Matters Partner
of Tesoro Drive Partners, et al.,

Respondents.

**On Writ Of Certiorari To The
United States Court Of Appeals
For The Fifth Circuit**

BRIEF OF SCOTT AND AUDREY BLUM AS AMICI CURIAE IN SUPPORT OF RESPONDENTS

CHRISTOPHER M. REIMER
Counsel of Record
LONG REIMER WINEGAR BEPPLER LLP
270 West Pearl Street, Suite 103
P.O. Box 3070
Jackson, Wyoming 83001
307.734.1908
creimer@lrw-law.com

Counsel for Amici Curiae

COCKLE LEGAL BRIEFS (800) 225-6964
WWW.COCKLELEGALBRIEFS.COM

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INTEREST OF AMICI CURIAE

Amici, Scott and Audrey Blum, are married taxpayers who have a clear interest in proper resolution of the sole substantive question before the Court. The Commissioner has sought to impose similar overvaluation penalties against them based on their 1998 participation in an investment known as the Offshore Portfolio Investment Strategy (OPIS).[1] Amici reported losses resulting from OPIS on their 1998 and 1999 federal income tax returns. In 2005, the Commissioner sought to disallow the losses, claiming that OPIS lacked economic substance, and impose accuracy-based penalties in connection with underpayments attributable to negligence and a gross valuation misstatement. The U.S. Tax Court held that OPIS lacked economic substance and, in the absence of controlling authority from the federal circuit with jurisdiction of amici's appeal, chose to apply the precedent of the U.S. Tax Court and held that amici's alleged underpayment resulting from OPIS could be attributable to a gross valuation misstatement under 26 U.S.C. § 6662 (Section 6662). Amici's appeal is currently before the U.S. Court of Appeals for the Tenth

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[1] Pursuant to Supreme Court Rule 37, letters of consent from the parties have been filed with the Clerk of the Court. In accordance with Rule 37.6, amici state that no counsel for either party has authored this brief in whole or in part, and no person or entity, other than amici, has made a monetary contribution to the preparation or submission of this brief.

Circuit, which has not yet addressed the 40% penalty issue.

SUMMARY OF ARGUMENT

1. A tax underpayment resulting from a transaction disregarded as lacking economic substance cannot be attributable to a valuation misstatement under Section 6662.

a. Resolving this question begins and ends with the text of the statute. The unambiguous, plain meaning of "attributable to" makes it logically impossible for an underpayment to be caused by both a valuation misstatement and a transaction entirely lacking in economic substance. Imposition of the 40% penalty depends not on whether a taxpayer has claimed a benefit from a valuation misstatement, but on whether the misstatement itself *caused* the underpayment. An underpayment cannot have been caused by a valuation misstatement if the taxpayer's liability would have been identical regardless of the misstatement's existence.

b. The Court should refrain from using nontextual policy concerns to rewrite the plain text of the statute as adopted by a popularly elected branch of the federal government: Congress. When faced with unclear evidence of legislative intent, the safest course is to simply apply the plain meaning of the statutory language as it is written, rather than attempt to use vague and

contradictory evidence to divine Congress's true intent in enacting Section 6662.

c. Treasury Regulations deeming an underpayment resulting from a disregarded transaction as attributable to a gross valuation misstatement based on a property value of zero exceed the Department of Treasury's rulemaking authority because they are not reasonable interpretations of Section 6662.

2. Even if an underpayment resulting from a transaction lacking economic substance can be attributable to a valuation misstatement, Section 6662's 40% penalty does not apply unless there is a finding of fact that the taxpayer misstated the value of property claimed on a tax return.

ARGUMENT

The valuation misstatement penalty does not apply to an underpayment of tax resulting from a determination that a transaction lacks economic substance.

I. Tax underpayments resulting from a determination that a transaction lacks economic substance are not "attributable to" a valuation misstatement.

The Petitioner's brief goes to great lengths to construe a simple statute in a complex manner. Its tortuous position is based largely on public policy considerations not contained in the terms of the

statute. The Court should refrain from imposing a strained logical scheme on the statute to arrive at what the IRS believes to be the proper policy outcome. Instead, it should interpret Section 6662 as actually codified by Congress.

If the Court applies the statute as written, the answer to the sole substantive issue in this case is simple: an underpayment resulting from a loss that was disallowed for lack of economic substance cannot have been caused by (and therefore "attributable to") a valuation misstatement of any kind because the value of property used in a disregarded transaction (and, therefore, the taxpayer's basis) is a mere nullity, having no effect on the taxpayer's ultimate income tax liability. No attempt to recharacterize a transaction lacking economic substance, itself, as a gross valuation misstatement can change this simple statutory analysis.

A. Under the plain text of Section 6662, an underpayment resulting from the disallowance of a transaction lacking economic substance is not "attributable" to a valuation misstatement.

Compared to other sections of an increasingly dense Internal Revenue Code, the statutory provisions involved in this case are straightforward. Section 6662 imposes a 20% penalty on an underpayment attributable to a substantial valuation misstatement. 26 U.S.C. § 6662(a), (b)(3). A taxpayer

makes a substantial valuation misstatement if he or she claims the value or adjusted basis of property on an income tax return that is 150% or more of the correct amount. *Id.* § 6662(e)(1)(A). The penalty increases to 40% if the underpayment is attributable to a gross valuation misstatement, which includes a misstatement of property value that is 400% or more of the correct amount. *Id.* § 6662(h)(1).

Regardless of the severity of the graduated valuation misstatement penalties, their common element is the requirement that the taxpayer's underpayment be "attributable" to the misstatement. It is not enough for the Commissioner to show that a valuation misstatement occurred: there must be a causal connection between the misstatement and the taxpayer's resulting tax underpayment. The crux of this case involves the question of whether an underpayment caused by a transaction that has been treated as a nullity under the economic substance doctrine can be logically "attributable" to a valuation misstatement.

The Court's rules of statutory construction are well known: "'[W]e start, of course, with the statutory text,' and proceed from the understanding that '[u]nless otherwise defined, statutory terms are generally interpreted in accordance with their ordinary meaning.'" *Sebelius v. Cloer*, 133 S. Ct. 1886, 1893 (2013) (quoting *BP America Prod. Co. v. Burton*, 549 U.S. 84, 91 (2006)). The Court presumes that Congress "says in a statute what it means and means in a statute what it says." *BedRoc Ltd. v. United States*, 541 U.S.

176, 183 (2004). Consequently, the Court's "inquiry ceases [in a statutory construction case] if the statutory language is unambiguous and the statutory scheme is coherent and consistent." *Cloer*, 133 S. Ct. at 1895 (internal quotation marks omitted).

The Internal Revenue Code does not define the meaning of the phrase "attributable to" for the purpose of Section 6662. The Court should therefore apply its ordinary meaning. *Id.* at 1893. The meaning of "attribute," the root verb of "attributable," is not controversial: "to regard as resulting from a specified cause; consider as caused by something indicated (usually by *to*)." *Attributable Definition*, Dictionary.com, http://dictionary.reference.com/browse/attributable (last visited Nov. 17, 2012); *accord Webster's II New Riverside Dictionary* 46 (Rev. ed. 1996) ("To regard or explain as arising or resulting from a source or cause."). The IRS' brief cites a similar definition. *See Webster's Third New International Dictionary of the English Language* 141, 142 (1993). The common feature of each definition is that there must be a causal connection between the occurrence of one item and another. It is not enough that an income tax underpayment and a valuation misstatement coincide – the misstatement must have been the specific *cause* of the underpayment.

No amount of clever reasoning can negate the clear meaning of the language of Section 6662. The 40% penalty is inappropriate unless the taxpayer's underpayment has been caused by a valuation misstatement. An event (i.e., an income tax underpayment) is

not caused[2] by a prior event (i.e., a valuation misstatement) if the event would have occurred in the exact same manner regardless of whether the prior event happened or not.

The common law economic substance doctrine and related anti-tax abuse doctrines have been in use at least since 1935, when the Court issued its *Gregory v. Helvering* decision. 293 U.S. 465 (1935). Despite common sources and principles, different courts have articulated varying interpretations of how to apply the economic substance doctrine to a particular case. Deciding whether a transaction should be disregarded for lack of economic substance often depends on extrinsic factors, including the taxpayer's motives and expert economic analyses of the profit potential of complex transactions. For example, the U.S. Court of Appeals for the Tenth Circuit, the court before which amici's appeal of their own 40% penalty lies, applies a two-prong test, examining a transaction's objective and subjective characteristics not as separate prongs, but as "more precise factors to consider in the determination of whether the transaction has any

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[2] Causation can raise thorny metaphysical questions, which would bring us far afield from the issues before the Court. Nonetheless, counterfactuals provide a useful method of determining whether event *x* "caused" event *y*. *See* Peter Menzies, *Counterfactual Theories of Causation*, Stanford Encyclopedia of Philosophy (2001) (citing David Hume, *An Enquiry Concerning Human Understanding* (1748)), http://plato.stanford.edu/entries/causation-counterfactual/. If event *y* would have happened regardless of the occurrence of event *x*, then *x* cannot be said to have caused *y*.

practical economic effects other than the creation of income tax losses." *James v. Comm'r*, 899 F.2d 905, 908-09 (10th Cir. 1990) (internal brackets and quotation marks omitted).

In both Woods's and amici's cases, the relevant trial court applied the economic substance doctrine and found that the relevant investment lacked economic substance. *See Woods v. United States*, 794 F. Supp. 2d 714, 716 (W.D. Tex. 2011); *Blum v. Comm'r*, T.C. Memo. 2012-16, at *3. Consequently, each court disregarded the transactions in their entirety and held that taxpayers were not entitled to claim losses from their respective transactions. *See Woods*, 794 F. Supp. 2d at 717; *Blum*, T.C. Memo. 2012-16, at *40. They did so not because the taxpayers claimed an incorrect basis in property, but because the transactions lacked subjective and objective economic substance. It is true that the taxpayers claimed different tax benefits based on the sizes of their respective cost bases (and thus the claimed losses). However, regardless of the size of the tax benefit allegedly sought by the taxpayer, the resulting tax liability (and thus the underpayment) would be the same. Whether Woods claimed the options involved in his COBRA investment had a basis of $0 or $1 billion, the entire transaction would be disregarded, thereby preventing him from claiming any COBRA losses and resulting in the same income tax underpayment.

The statute does not impose a penalty based on the mere existence of a valuation misstatement. It

also does not impose a penalty based on whether a taxpayer attempted to claim a benefit from a valuation misstatement. Congress could have codified those grounds for a valuation misstatement penalty when it adopted the version of Section 6662, as it existed during Woods's COBRA transaction. It also could have provided an independent basis for imposing a penalty on transactions lacking economic substance, as it in fact did when it codified the economic substance doctrine in 2010. *See* Health Care and Education Reconciliation Act of 2010, Pub. L. No. 111-152, § 1409(a), (b)(1) (2010). This would have accomplished the goal Petitioner attributes to Congress in a much less convoluted fashion than expecting the IRS, taxpayers, and courts to realize that transactions lacking economic substance represent valuation misstatements in themselves. Regardless of whether the IRS now believes that such a codification would have been an advisable means of deterring abusive tax shelters, Congress failed to address these concerns in the statutory text.

Having repeatedly failed to challenge the 40% rule articulated by the Fifth and Ninth Circuits in *Todd v. Commissioner*, 862 F.2d 540 (5th Cir. 1988) and *Gainer v. Commissioner*, 893 F.2d 225 (9th Cir. 1990) on policy grounds, the IRS' brief proposes a more nuanced argument. It proposes that Section 6662 imposes a 40% penalty not only on underpayments attributable to factual valuation misstatements, but also on those attributable to what the IRS characterizes as basis misstatement resulting from the

operation of law. (Br. for the United States 41.) The IRS goes on to argue that the distinction between a factual and legal valuation misstatement is inconsequential and that, in either case, the taxpayer is subject to the same 40% penalty for a payment attributable to a valuation misstatement.

To arrive at this conclusion, the IRS cites the district court's finding that "the whole point of the COBRA strategy" was to create a paper loss through a misstatement of the basis of partnership property. (Br. for the United States 40). At most, this shows that the taxpayers or COBRA promoters subjectively intended to receive a tax benefit from a valuation misstatement. It does not show that a valuation misstatement caused the parties' actual underpayment.

Even if the IRS is correct that a transaction lacking economic substance represents a legal, rather than a factual, valuation misstatement, that does not mean that the taxpayer's resulting underpayment was *caused* by that misstatement. It simply begs the question of whether the taxpayer's underpayment was caused by (and therefore attributable) to a valuation misstatement or, perhaps, whether the underpayment and legal valuation misstatement were both caused by a third event: the fact that the transaction lacked economic substance. One of the classic problems of causation involves the question of whether one event really caused another. For example, the two events may simply coincide with no causal connection

to each other. Another possibility more relevant to this case is that a third event caused both events. Here, the latter possibility is likely. Rather than being caused by a valuation misstatement, Woods's underpayment and the valuation misstatement (to the extent that there was one) both resulted from the same source: the fact that COBRA had no economic substance. The economic substance doctrine's primary effect is to prevent Woods from claiming any losses from COBRA. Perhaps, in a technical sense, that also caused there to be no basis in Woods's property.[3] But that does not demonstrate that Woods's underpayment was *attributable to* a valuation misstatement. The effect on the basis is simply an irrelevant side product of the economic substance doctrine, with no practical effect on Woods's ultimate tax liability because the entire transaction is deemed to have not taken place.

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[3] It is not necessarily the case that property involved in a disregarded transaction has a basis of zero. The truth of taxpayer's value and basis representations is akin to the truth of the phrase, "The present King of France is bald." *See* Bertrand Russell, *On Denoting*, 14 Mind 479, *reprinted in*, *The Collected Papers of Bertrand Russell, Vol. IV: Foundations of Logic* 414, 419 (A. Urquhart & A. Lewis eds., 1994). As in that sentence, there is a sense in which the claimed basis is neither true nor false, since there is no present King of France; similarly the transaction in question is a nullity.

B. The Court should apply the plain meaning of the statute as codified by Congress, regardless of non-textual considerations of legislative policy.

As the IRS points out, many lower courts have rejected or criticized the valuation misstatement rule articulated by Woods and the Fifth and Ninth Circuit appellate courts. *See, e.g.*, *Merino v. Comm'r*, 196 F.3d 147, 155 (3d Cir. 1999). At first blush, this approach can seem reasonable because it allows the IRS to impose harsher penalties on taxpayers who have engaged in allegedly more serious tax misconduct. These kinds of policy intuitions may provide the primary explanation for why so many appellate courts have concluded in the Commissioner's favor on this issue. *See, e.g.*, *Gustashaw v. Comm'r*, 696 F.3d 1124, 1136-37 (11th Cir. 2012) (referring to the need to "penalize and discourage" valuation misstatements); *Fidelity Int'l Currency Adv. A Fund, LLC ex rel. Tax Matters Partner v. Comm'r*, 661 F.3d 667, 673 (1st Cir. 2011) (same); *Clearmeadow Invs., LLC v. United States*, 87 Fed. Cl. 509, 534 (2009) (arguing that Congress could not have intended this result). "Why," the common sense argument goes, "should a taxpayer who engages in a transaction that is illegitimate in its entirety be given more favorable treatment than a taxpayer who engages in a legitimate transaction, but claims an inflated basis in property on his or her tax return?"

While perhaps well meaning, this post hoc, results-driven approach misunderstands the federal

executive and judicial branches' authority to interpret and enforce federal tax statutes. Our government consists of multiple branches, each with its own constitutionally prescribed powers and duties. *See* The Federalist No. 47, at 233-34 (James Madison) (Terence Ball ed., 2003) (articulating the philosophical basis for the separation of powers as a bulwark against tyranny). Simply put, Congress writes laws, executive agencies enforce them, and courts interpret them. Sometimes, Congress (like all legislatures) makes what turn out to be, in arguable hindsight, bad decisions. That may be inevitable for a popularly elected body adopting generally applicable laws to address future problems. But that does not mean that courts get to go back and second-guess Congress's policy decisions after the fact, no matter how much the courts may disagree with those decisions. In our framework of divided government, the role of this Court is merely to interpret laws and, if they have an unambiguous plain meaning that does not violate the U.S. Constitution, enforce that meaning.

The Petitioner's arguments about Congress's broader purpose of deterring abusive tax shelters are similarly unavailing. Congress is a heterogeneous body composed of a multitude of competing interests. Even when it is seemingly unanimous about fighting a commonly recognized evil, such as tax shelters, its members must address those vague purposes with concrete statutory language, often requiring difficult compromises over the final wording of a statute. *Bd. of Governors of Fed. Res. Sys. v. Dimension Fin.*

Corp., 474 U.S. 361, 373-74 (1986). This is particularly true in the context of U.S. fiscal policy. As this Court recognized over a century ago:

> What is termed the policy of the government with reference to any particular legislation is generally a very uncertain thing, upon which all sorts of opinions, each variant from the other, may be formed by different persons. It is a ground much too unstable upon which to rest the judgment of the court in the interpretation of statutes. Where the language of the act is explicit, this court has said, there is great danger in departing from the words used, to give an effect to the law which may be supposed to have been designed by the legislature. . . . It is not for the court to say, where the language of the statute is clear, that it shall be so construed as to embrace cases because no good reason can be assigned why they were excluded from its provisions.

Bate Refrigerating Co. v. Sulzberger, 157 U.S. 1, 37 (1895) (quoting *Denn v. Reid*, 35 U.S. 524, 527 (1836)) (internal quotation marks omitted).

Perhaps Congress could have better addressed the tax shelter problem by codifying a basis for imposing a 40% penalty on transactions lacking economic substance. But, despite having opportunities to fix what the IRS views as a mistake, Congress did not impose such a penalty until 2010. *See* Health Care and Education Reconciliation Act of 2010, Pub. L. No. 111-152, § 1409(a), (b)(1) (2010). Even when it did impose a penalty, it opted to do so not by clarifying

application of the valuation misstatement penalty, but by codifying an entirely new penalty based on economic substance itself. *See* 26 U.S.C. § 6662(b)(6). Whether Congress should have adopted this kind of legislation decades earlier or clarified the proper application of the valuation misstatement penalty presents academic questions for political economists. In the late 1990s, when promoters encouraged transactions like COBRA and OPIS, the Commissioner had the authority to impose only those penalties authorized by the statutory language then in effect. At that time, a 40% penalty was only permissible if a taxpayer's underpayment was attributable to a gross valuation misstatement.

Even if the statute is ambiguous and the Court may consider non-textual considerations, it is far from clear that policy and equitable considerations demand imposing the 40% penalty. Punishment of taxpayers who take advantage of abusive tax shelters may not have been the only legislative policy consideration before Congress. The small amount of information we have about Congress's intentions in adopting valuation penalties includes the fact that Congress likely enacted Section 6662's predecessor statute, 26 U.S.C. § 6659, to discourage taxpayers from overvaluing property in order to "divide the difference" with the IRS. *Todd*, 862 F.2d at 542 (citing H.R. Rep. No. 97-201, at 243 (1981)). First, this policy preference does not justify the IRS' attempt to recast losses claimed from a transaction lacking economic substance as a valuation misstatement. The plain

meaning of the statutory text trumps the amorphous intent that Congress did not codify into statutory language.

Second, the policy of deterrence through punishment must be balanced against other concerns, including the efficient use of judicial resources. It is plausible that Congress may have chosen not to impose a 40% penalty on transactions lacking economic substance in order to avoid forcing courts into unnecessarily complicated valuation disputes when a case can be more simply resolved with the common law economic substance doctrine.

As identified by both parties, the little legislative history available comes from the informal guidance of the *General Explanation of the Economic Recovery Tax Act of 1981*, or the "Blue Book," prepared by the Staff of the Joint Committee on Taxation. The Blue Book provides the most contemporary account of how Congress intended for courts and the IRS to apply the predecessor statute's version of the valuation misstatement penalty if underpayments are attributable to multiple adjustments. *See id.* at 333. It does so through a simple formula:

> The portion of a tax underpayment that is attributable to a valuation overstatement will be determined after taking into account any other proper adjustments to tax liability. Thus, the underpayment resulting from a valuation overstatement will be determined by comparing the taxpayer's (1) actual tax liability (i.e., the tax liability that results from

> a proper valuation and which takes into account any other proper adjustments) with (2) actual tax liability as reduced by taking into account the valuation overstatement. The difference between these two amounts will be the underpayment that is attributable to the valuation overstatement.

Id. The formal legislative history of an analogous penalty modeled on the predecessor to § 6662 suggests that this is the proper formula for determining the value of an underpayment attributable to a valuation misstatement. *Gainer*, 893 F.2d at 228 (citing H.R. Rep. No. 99-426, at 763 (1985)).

This guidance greatly simplifies the process of determining the amount of a taxpayer's penalty in this case, as well as in amici's OPIS investment.[4] One simply determines the difference between the taxpayer's tax liability if the taxpayer had correctly reported the basis of all property used in the transaction and the liability as reduced by the valuation misstatement. If the transaction itself lacks economic substance, then the taxpayer would have the exact same income tax liability regardless of proper valuation of property claimed on his or her income tax return. It would therefore be improper to hold a taxpayer in Woods's position liable for a 40% penalty

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[4] Woods's merits brief provides persuasive argumentation for why this kind of simplicity was one of the primary goals of the valuation misstatement penalties provided by Section 6662 and its predecessor statute. (Br. for Resp't 35.)

because *none* of his alleged underpayment is attributable to a valuation misstatement.

Despite Petitioner's claims to the contrary, the Blue Book says nothing about its formula applying only to special situations in which underpayments attributable to a valuation misstatement must be distinguished from those attributable to other adjustments. While the Blue Book notes that the portion of a tax underpayment attributable to an overstatement is determined after taking other adjustments into account, its language stating how to apply the penalty contains no qualifying language. Staff of the Jt. Comm. on Tax., *supra*, at 333. An additional Blue Book example supports this interpretation by determining an overvaluation penalty regarding the charitable donation of a painting (e.g., the amount of underpayment attributable to the overvaluation) solely based on the amount by which the overvaluation reduced the taxpayer's income tax liability. *Id.* at 334.

Finally, to the extent that there is a true ambiguity regarding how to apply Section 6662's governmental penalties, after considering the text, structure, history, and purpose of the statute, *see Maracich v. Spears*, 133 S. Ct. 2191, 2222 (2013), then the Court should apply the rule of lenity and resolve the question of construction in Woods's favor.

C. Treasury Regulations treating an underpayment resulting from a transaction disallowed under the economic substance doctrine as attributable to a valuation misstatement are erroneous and entitled to no deference.

Finally, the IRS argues that regulations adopted by the U.S. Department of Treasury require that Woods's underpayment be deemed attributable to a valuation misstatement. *See* 26 C.F.R. § 1.6662-5(g). According to that rule,

> The value or adjusted basis claimed on a return of any property with a correct value or adjusted basis of zero is considered to be 400 percent or more of the correct amount. There is a gross valuation misstatement with respect to such property, therefore, and the applicable penalty rate is 40 percent.

Id. The IRS argues that, since property used in a disregarded transaction has a basis of zero, the taxpayer's basis misstatement is necessarily 400% or more of the correct amount, requiring imposition of Section 6662's gross valuation misstatement penalty.

This argument assumes not only that the basis of property involved in a disregarded transaction has a value of zero, but also that the economic substance doctrine somehow causes the taxpayer's underpayment to be attributable to a valuation misstatement. Even if a disregarded transaction technically results in a basis of zero, that basis adjustment did not cause the taxpayer's underpayment and the underpayment

still cannot be properly attributed to the valuation misstatement.

As argued above, Congress's intent is clear. The plain language of the statute unambiguously provides that a 40% penalty is inappropriate in connection with an underpayment resulting from a transaction disregarded under the economic substance doctrine. If the statutory language is clear and unambiguous, that is the end of the matter and the agency is entitled to no deference. *See Chevron U.S.A. Inc. v. Nat. Res. Def. Cncl., Inc.*, 467 U.S. 837, 842-43 (1984). A Treasury Regulation in conflict with the plain meaning of Section 6662 is per se unreasonable and there is no need to make a multi-step *Chevron* analysis of whether the rules are unreasonable, *see United States v. Home Concrete & Supply, LLC*, 132 S. Ct. 1836, 1847 n.1 (2012) (citing Matthew C. Stephenson & Adrian Vermeule, Chevron *Has Only One Step*, 95 Va. L. Rev. 597, 599 (2009)), or to determine the amount of deference owed to the Department of Treasury by this Court, *see Smith v. City of Jackson, Miss.*, 544 U.S. 228, 267 (2005) ("[N]o deference is due to agency interpretations at odds with the plain language of the statute itself.") (internal quotation marks omitted).

II. The valuation misstatement penalty applies only to a factual misrepresentation of the value of property claimed on an income tax return, not to a basis reduced to zero by operation of law.

Even if the IRS is correct that an underpayment resulting from a transaction without economic substance can be attributable to a valuation misstatement, that simply raises the issue of how one should determine whether a valuation misstatement occurred in the first place. The IRS has argued that so-called "basis inflating" tax shelters disregarded on economic substance grounds necessarily constitute legal, if not factual, valuation misstatements. It therefore concludes that all such transactions trigger Section 6662's 40% penalty.

Assume for the sake of argument that a transaction's invalidation on economic substance grounds can have the legal effect of reducing the taxpayer's interest in property involved in the transaction (whether cattle, shipping containers, or complex financial derivatives) to zero. But this simply raises the question of whether this effect represents the kind of "valuation misstatement" contemplated by the text of Section 6662's 40% penalty.

As argued in Woods's merits brief (Br. for Resp't 35),[5] Section 6662's use of the term "valuation

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[5] Woods's brief makes other persuasive arguments based on the text, structure, and legislative history of Section 6662 for

(Continued on following page)

misstatement" strongly suggests that the 40% penalty requires a factual misstatement of the basis of property claimed on a tax return. *See* 26 U.S.C. § 6662(b). Questions of value, themselves, are matters determined by the trier of fact based on the entire record. *See, e.g.*, *Yates v. Comm'r*, T.C. Memo. 2013-28, at *12. Sitting as triers of fact, courts often determine issues of valuation in reliance on expert witness testimony. *Estate of Gallagher v. Comm'r*, T.C. Memo. 2011-148, at *5 (citing *Helvering v. Nat. Grocery Co.*, 304 U.S. 282, 295 (1938)). These kinds of questions can be very complicated, requiring a court to review a wide range of complex and often conflicting evidence, which helps to explain the very backlog of valuation cases that motivated enactment of the valuation misstatement penalty's predecessor provision, 26 U.S.C. § 6659, in the first place. *See* H.R. Rep. No. 97-201, at 243 (1981).

Whether a court should use the common law economic substance doctrine to invalidate an entire transaction is, by contrast, generally a question of law. The doctrine has its origins not in federal statutes, but has gradually evolved through a variety of related common law anti-abuse principles created by federal judges. *See Moline Props. Inc. v. Comm'r*, 319 U.S. 436 (1943) (sham transaction doctrine); *Sala v.*

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why a transaction lacking economic substance as a matter of law does not necessarily demonstrate that kind of factual valuation misstatement required to impose the 40% penalty. (Br. for Resp't 33-46.)

United States, 613 F.3d 1249, 1253 (10th Cir. 2010) (economic substance doctrine); *Frank Lyon Co. v. United States*, 435 U.S. 561 (1978) (business purpose doctrine); *Minnesota Tea Co. v. Helvering*, 302 U.S. 609 (1938) (substance over form doctrine); *Comm'r v. Gordon*, 391 U.S. 83 (1968) (step transaction doctrine). A unifying theme of these common law doctrines has been that invalidation of a transaction is generally a question of law. For example, while determining whether a transaction lacks economic substance arguably raises mixed questions of law and fact, the U.S. Court of Appeals for the Tenth Circuit treats such determinations like questions of law and subjects them to de novo review. *Sala*, 613 F.3d at 1252.

Courts' disparate treatment of questions of valuation and those of economic substance illustrates the stark differences between the situations to which Section 6662's 40% penalty applies and transactions disregarded for lack of economic substance. The two inquiries pose separate questions, which the IRS has improperly sought to conflate into a single question whereby every alleged basis inflating transaction lacking economic substance (a question of law) necessarily leads to a finding of fact that a taxpayer misstated the value of property on his or her return (the so-called "basis-overstatement penalty").

Take, for example, the case of amici. The IRS sought to disallow losses connected to their investment in OPIS, which was a complex series of investments in derivatives based on the price of UBS stock.

They fell afoul of the economic substance doctrine by allegedly executing a series of prearranged steps, the objective and subjective features of which the IRS and U.S. Tax Court determined were undertaken to create artificial tax losses, rather than reasonable profits. *See Blum*, T.C. Memo. 2012-16, at *31. Notably, the Tax Court did not address the questions of whether amici engaged in the trades composing OPIS nor the actual value of the options involved. Rather, it held that the issue of value or basis in the OPIS options was moot "[b]ecause . . . the OPIS transaction lacked economic substance and related losses are disallowed without regard to the value or basis of the assets." *Id.* at *38 n.22. Assuming OPIS lacked economic substance, the Tax Court would have been correct that it should be disregarded as a matter of law and that no valuation of amici's basis in the options would be necessary. However, the court erred in assuming that this inevitably led to the conclusion that amici were liable for a gross valuation misstatement penalty, which, based on the plain language, structure and legislative history of Section 6662, applies only to a factual misstatement of property value claimed on a tax return. Imposing a 40% penalty in such a situation would be inappropriate because the taxpayers would not have engaged in the conduct designed by Congress as triggering the penalty (a gross misvaluation of property as a matter of fact).

CONCLUSION

For these reasons, and those in Respondent's brief, the Court should affirm the court of appeals' decision that an underpayment resulting from a transaction lacking economic substance is not attributable to a valuation misstatement.

Respectfully submitted,

CHRISTOPHER M. REIMER
Counsel of Record
LONG REIMER WINEGAR
BEPPLER LLP
270 West Pearl Street, Suite 103
P.O. Box 3070
Jackson, Wyoming 83001
307.734.1908
creimer@lrw-law.com

Counsel for Amici Curiae

AMICUS CURIAE BRIEF

RECORD
AND
BRIEFS

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In the Supreme Court of the United States

UNITED STATES,

Petitioner,

v.

GARY WOODS, as Tax Matters Partner of Tesors Drive Partners, et al.,

Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

BRIEF OF *AMICI CURIAE* GORDON W. BUSH, ET AL. IN SUPPORT OF RESPONDENT

Thomas E. Redding, *Counsel of Record*
Sallie W. Gladney,
Redding & Associates, P.C.
2916 West T.C. Jester, No. 102
Houston, TX 77018
(713) 965-9244/(713) 621-5227 (Fax)
Service@ReddingTaxLaw.com

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INTEREST OF THE *AMICI CURIAE*[1]

Amici are the taxpayers listed in Addendums A-D, Kenneth A. Kercher, Suzanne B. Kercher, Alfonso Varela, Sandra Santa Maria Varela, and Charles Mangum. Each is a party to one of the following (collectively "*amici*'s suits"):

- *Bush, et. al v. United States* (Fed.Cir. 12-5051), petition pending for rehearing and rehearing *en banc* regarding 2013 U.S.App.LEXIS 10879 (Fed. Cir. 2013);
- *Kercher, et ux v. United States* (5th Cir. 12-40483), appeal pending from 2010 U.S. Dist. LEXIS 121259 (E.D.Tex. 2010) and 2012 U.S. Dist. LEXIS 34600 (E.D.Tex. 2012);
- *Varela, et ux v. United States* (5th Cir. 12-20359), appeal pending from 2011 U.S. Dist. LEXIS 58621 (S.D. Tex. 2011), and 2012 U.S. Dist. LEXIS 73897 (S.D. Tex. 2012);
- *Irvine, et. al v. United States* (5th Cir. 12-20523), appeal pending from 2012 U.S. Dist. LEXIS 60083 (S.D. Tex. 2012);
- *Acute Care Specialists II, Ltd., et. al v. United States* (7th Cir. 12-1212), appeal pending from 2011 U.S. Dist. LEXIS 144155 (N.D. 2011);

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[1] This brief is filed with the written consent of both parties. Supreme Court Rule 37.3(a). *Amici* certify that this brief was not authored in whole or in part by counsel for either party and that *amici* received no monetary contribution toward the preparation or submission of this brief. Supreme Court Rule 37.6.

- *Fillmore Equip. of Holland, Inc., et. al v. United States* (Fed.Cir. 13-5048), petition for a writ of certiorari to the Federal Circuit anticipated to be filed shortly regarding 2013 U.S. App. LEXIS 12511 (Fed. Cir. 2013); and

- *Mangum v. Commissioner* (T.C. 1288-12), 26 U.S.C. §6330 appeal from a collection due process (CDP) hearing pending before the Tax Court.

The Court instructed the parties to brief the jurisdictional character and scope of 26 U.S.C. §6226.[2] Claims in each *amici* suit turn on that issue. While both the United States and Woods assume, without analysis, that §6226(f) is jurisdictional, some courts treat §6226 provisions as nonjurisdictional and subject to waiver or alteration.[3] *Amici* urge the Court to establish and apply the *test* that determines the jurisdictional character of tax statutes, rather than simply assuming that character.

Other issues in this case that, if addressed or assumed, will directly impact the *amici*'s suits include whether:

- the 1997 amendments to §6226 provisions apply for all tax years;

- a statute's jurisdictional character applies to its

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[2] *United States v. Woods*, 133 S. Ct. 1632, 185 L. Ed. 2d 615 (2013).

[3] For example, see *Prati v. United States*, 603 F.3d 1301, 1307-08 and n.4 (Fed.Cir. 2010) (endorsing the Tax Court's waiver of pre-1997 §6226(d)(1)(B)).

effective date;

- the statutory definition of "partnership item" may be judicially expanded to encompass "affected items" on the rationale that, but for partnership items, there would be no affected items;
- the undefined term "attributable to" mandates a direct causal link or whether an indirect, second-hand, or one-step-removed relationship will suffice for tax statutes; and
- the phrase "relates to *an adjustment to* a partnership item" in §6226(f) may be read as "relates to a partnership item."

TEFRA is not limited only to partnerships that may be tax shelters. This Court's jurisdictional holding will directly impact virtually every partner in every TEFRA partnership. It will be especially felt by the thousands of small investors who, like *amici*, were limited partners and now find themselves penalized due entirely to partnership-level actions taken without their knowledge and in which they, as limited partners, could not participate.

Here, the United States attacks the Fifth Circuit's application of the "Blue Book" formula that determines the portion of an underpayment subject to the §6662 penalty. *Amici* suits involve the "penalty" rate of interest under former §6621(c). The government has attempted to use questions regarding that Blue Book formula to undermine the Internal Revenue Service's (IRS's) similar formula formally promulgated and adopted in Treas.Reg. §301.6621-2T, A-5, which determines the portion of an underpayment subject to

penalty interest.[4] The Fifth and Federal Circuits are split on whether the Secretary is required to apply its own regulation.[5] This Court's resolution of how to determine the portion of an underpayment subject to the §6662 penalty is anticipated to directly impact *amici*'s penalty interest cases.

SUMMARY OF THE ARGUMENT

Arbaugh and *Henderson* establish the general test for jurisdictional character of all federal statutes, including tax, unless a specific test applies.[6] No specific test applies to §6226. Under *Arbaugh/Henderson*, §6226 provisions (except subsection (h)), the effective dates of their 1997 amendments, and §6233 (to the extent it impacts partnership-level suits) are jurisdictional.

To the extent provided by regulation, §6233 imposes TEFRA §6221 *et seq.* partnership provisions on any entity that files a partnership return, its items,

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[4] See the Brief for the Appellee pp. 62-63, n. 14 (Doc. 00512139781, Feb. 8, 2013) filed in *Irvine*.

[5] *Weiner v. United States*, 389 F.3d 152, 159-163 (5th Cir. 2004), (where an underpayment is attributable to two independent, separable grounds, one supporting penalty interest and one not, under Treas.Reg. §301.6621-2T, A-5, the portion subject to penalty interest is 0 (100% - 100% = 0); *Prati*, 603 F.3d at 1308 (in that same scenario, applying Treas.Reg. §301.6621-2T, A-5 "would invalidate the determination" that supports penalty interest).

[6] *Arbaugh v. Y & H Corp.*, 546 U.S. 500, 546, 126 S. Ct. 1235, 163 L. Ed. 2d 1097 (2006); *Henderson v. Shinseki*, 131 S. Ct. 1197, 179 L. Ed. 2d 159 (2011).

and persons holding an interest in such entity, regardless of whether the entity is a partnership and even if it is determined that there is no entity. Neither the Internal Revenue Code nor regulations, however, make clear how to apply §6233 once a court determines the partnership is a "sham" to be disregarded for tax purposes.

As relevant, the scope of §6226(f) partnership-level jurisdiction for tax year 1999 is limited to adjusting and allocating partnership items and "the applicability of any penalty . . . which relates to *an adjustment to a partnership item*" (emphasis added).

Tax statutes are strictly cons rued, and the phrase "attributable to" mandates direct causal relationships—indirect, attenuated, "but for" relationships are not enough. Similarly, affected items may not be reclassified or treated as partnership items simply because they would not exist but for partnership items.

Because §6226(f) and §6233 are jurisdictional, their terms may not be waived or altered. Consequently, the district court did not have jurisdiction to determine the §6662 substantial valuation misstatement (SVM) penalty because:

- once a partnership is determined to be a sham and disregarded for tax purposes, all further proceedings should be conducted at the partner level, and §6233 should be construed to confer jurisdiction only to make the sham determination and dismiss the suit;
- even if the "hypothetical partnership" treatment

under §6233 applies to a "sham" partnership, §6226(f) confers jurisdiction only to determine the applicability of a penalty based on determinations of adjustments to what would be partnership items, not affected items, specifically outside basis; and

- the district court made no valuation or basis determinations; therefore, on these facts, it had no jurisdiction to determine the applicability of penalties where no adjustments they might relate to were made, nor did it have jurisdiction to determine losses not claimed by the partnership at all.

If the district court had jurisdiction of the SVM penalty, then it correctly held that §6662(b)(3)'s restriction of that penalty to apply to "the portion of any underpayment attributable to . . . [a]ny [SVM]" precludes its application where deductions are disallowed on grounds other than valuation.

If the inapplicability of the SVM penalty is reversed, then the Court should make clear that:

- its analysis of the precedential or persuasive impact of the "Blue Book" formula does not implicate the similar formula formally prescribed by the Secretary in Treas.Reg. §301.6621-2T, A-5, to determine the portion of an underpayment attributable to a tax motivated transaction (TMT) for purposes of imposing "penalty" interest under former §6621(c); and

- its ruling does not apply where there is no

> ultimate, affirmative finding of an overvaluation in the relevant partnership-level proceeding.

ARGUMENT

1. Jurisdiction

The Court ordered the parties to address:

> Whether the district court had jurisdiction in this case under 26 U.S.C. §6226 to consider the substantial valuation misstatement penalty.

Woods, 133 S. Ct. at 1632.

The answer depends on the jurisdictional character and scope of §6226 and the tax year involved.

a. Test for Jurisdictional Character of Tax Statutes

There is no specific test for the jurisdictional character of tax statutes. This Court's guidance is needed to clarify that the *Arbaugh/Henderson* test applies to §6226 provisions.

Jurisdictional statutes cannot be waived or altered. The Fifth and Federal Circuits split on whether §6226 provisions are jurisdictional. The Fifth Circuit holds §6226(b) and (f) are jurisdictional and cannot be altered.[7] The Federal Circuit treats §6226(d)(1)(B) and (f) as nonjurisdictional by holding that partnership-level courts may waive §6226(d)(1)(B) and expand

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[7] *A.I.M. Controls, LLC v. Commissioner*, 672 F.3d 390, 395 (5th Cir. 2012).

§6226(f) to encompass nonpartnership-items.[8] Therefore, the threshold issue in answering the Court's question is identifying the test for jurisdictional character of tax statutes.

Arbaugh established congressional intent as the "readily administrable bright line" test in Article III courts.[9] *Henderson* articulated factors and extended that test to "review by an Article I tribunal as part of a unique administrative scheme."[10]

The Fifth Circuit applies *Henderson* to determine the jurisdictional character of TEFRA's §6226 provisions.[11] The Federal Circuit rejects application of *Henderson* to §6226, asserting *Henderson* concerned a veterans statute and not the partnership tax issues in §6226.[12]

This Court broadly applies the *Arbaugh*/*Henderson* test.[13] Every circuit, including the Federal

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[8] *Prati*, 603 F.3d at 1307-08 and n.4.

[9] *Arbaugh*, 546 U.S. at 546.

[10] *Henderson*, 131 S. Ct. at 1202-06.

[11] *A.I.M. Controls*, 672 F.3d at 393-95.

[12] *Fournier v. United States*, 2012 U.S.App. LEXIS 24525, *7 (Fed.Cir. 2012).

[13] *Mann v. United States*, 131 S. Ct. 1598, 179 L. Ed. 2d 496 (2011) (criminal); *Stern v. Marshall*, 131 S. Ct. 2594, 180 L. Ed. 2d 475 (2011) (bankruptcy); *Sebelius v. Auburn Reg'l Med. Ctr.*, 133 S. Ct. 817, 184 L. Ed. 2d 627(2013) (Medicare); and *Gonzalez v. Thaler*, 132 S. Ct. 641, 181 L. Ed. 2d 619 (2012) (Antiterrorism and

Circuit (except as to §6226),[14] broadly applies *Arbaugh/Henderson*'s general test to federal statutes, unless a more specific test applies.[15]

b. Under the *Arbaugh/Henderson* Test 26 U.S.C. §6226(a)-(g) are Jurisdictional

Statutes have adjudicatory authority if they delineate the classes of cases (subject-matter jurisdiction) and the persons (personal jurisdiction) implicating that authority.[16] Jurisdictional character attaches whether a statute grants or limits a grant of

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Effective Death Penalty Act of 1996).

[14] *Palacios v. United States*, 2012 U.S. App. LEXIS 5014 (Fed. Cir. 2012) (unpublished), *aff'g* 100 Fed. Cl. 656 (2011) (summarily affirming *Henderson*'s broad general scope). F.R.A.P. 32.1.

[15] *Alphas Co. v. William H. Kopke, Jr., Inc.*, 708 F.3d 33 (1st Cir. 2013); *City of New York v. Mickalis Pawn Shop, LLC*, 645 F.3d 114 (2d Cir. 2011); *NLRB v. New Vista Nursing & Rehab.*, 2013 U.S. App. LEXIS 9860 (3rd Cir. 2013); *United States v. Wilson*, 699 F.3d 789, 793-97 (4th Cir. 2012); *La. Envtl. Action Network v. City of Baton Rouge*, 677 F.3d 737, 745-49 (5th Cir. 2012); *Brentwood at Hobart v. NLRB*, 675 F.3d 999, 1002-05 (6th Cir. 2012); *In re IFC Credit Corp.*, 663 F.3d 315, 319-20 (7th Cir. 2011); *Mader v. United States*, 654 F.3d 794, 805-08 (8th Cir. 2011); *Payne v. Peninsula Sch. Dist.*, 653 F.3d 863, 867-71 (9th Cir. 2011) (*en banc*); *United States v. McGaughy*, 670 F.3d 1149 (10th Cir. 2012); *Avila-Santoyo v. AG*, 713 F.3d 1357 (11th Cir. 2013) (*en banc*); and *Netcoalition & Secs. Indus. & Fin. Mkts. Ass'n v. SEC*, 715 F.3d 342 (D.C. Cir. 2013).

[16] *Kontrick v. Ryan*, 540 U.S. 443, 455, 124 S. Ct. 906, 157 L. Ed. 2d 867 (2004).

jurisdiction.[17] Congress can attach jurisdictional conditions to rules that courts would prefer to call claim-processing rules.[18]

Under *Arbaugh*, an enactment is jurisdictional if Congress "clearly states that a threshold limitation on a statute's scope shall count as jurisdictional."[19]

Section 6226 is titled "Judicial Review of Final Partnership Administrative Adjustments" (FPAAs). No other statute controls judicial review of FPAAs.

Subsection (f) is titled "Scope of Judicial Review" and for all tax years states that:

> [a] court with which a petition is filed [under] this section shall have jurisdiction to determine all partnership items of the partnership for the partnership taxable year to which the [FPAA] relates and the proper allocation of such items among the partners . . . .

Subsections (c), (d), and (e), as well as §6231(a)(3)'s definition of "partnership item," all clearly impose a threshold limitation on the scope of partnership-level jurisdiction. The jurisdictional label was expressly attached to §6226(c), (d), (e), (f), and §6231(a)(3) (for purposes of §6226(f)).

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[17] *Gonzalez*, 132 S.Ct. at 648-49.

[18] *Henderson*, 131 S.Ct. at 1203.

[19] *Gonzalez*, 132 S.Ct. at 648, quoting *Arbaugh*, 546 U.S. at 515.

Henderson's factors determine a statute's jurisdictional character when the word "jurisdiction" is missing. They include whether:

- the provision's text clearly evidences intent to carry jurisdictional consequences, *i.e.*, it speaks in jurisdictional terms or refers to a court's jurisdiction;
- its placement within the statutory scheme evidences jurisdictional intent:
- another provision prescribes that jurisdiction;
- those subject to the scheme are due equitable deference; and
- Congress has left undisturbed a long line of this Court's decisions treating that or a similar provision as jurisdictional.[20]

Subsections (a), (b)(1), (b)(5), and (d)(2) restrict the classes of persons who may file a petition and dictate filing periods.

Subsections (b)(6),[21] (c), and (d) establish or restrict the classes of persons (i) who may be parties, and (ii) who (parties or non-parties) may participate.

Subsections (b)(2)-(5)[22] determine which of duplicate suits are dismissed.

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[20] *Henderson*, 131 S.Ct. at 1203-06 and cases cited therein.

[21] Designated (b)(5) for pre-1997 tax years.

[22] Subsections (b)(2)-(4) and (b)(6) for pre-1997 tax years.

Subsection (e) prescribes additional "jurisdictional requirement[s]" to sue in federal district court or the Court of Federal Claims (CFC).

Subsection (g) restricts the classes of persons who may appeal.

Only subsection (h) ("Effect of Decision Dismissing Action") goes to the effect of adjudication rather than authority to adjudicate.

Subsections (a)-(g) expressly or implicitly speak in jurisdictional terms and place threshold limits on a partnership-level court's adjudicatory authority.

Henderson's factors reinforce that subsections (c), (d), (e), and (f) are jurisdictional and clarify congressional intent that the jurisdictional label attach to subsections (a), (b), and (g).

Those factors also extend jurisdictional impact to §6231(a)(3)'s definition of "partnership item" to the extent it limits §6226's jurisdictional provisions, including (f); consequently, that definition is strictly construed and cannot be waived or altered. The Tax Court has recently acknowledged the importance of the definition of "partnership items" in determining partnership-level jurisdiction.[23]

In *A.I.M. Controls*, the Fifth Circuit held that, unlike the veterans filing deadline in *Henderson*, the

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[23] *6611, Ltd. v. Commissioner*, T.C. Memo 2013-49, *P45 (Feb. 14, 2013).

§6226(b) filing deadline is jurisdictional.[24] It recognized that, unlike the deference owed to veterans, rigid jurisdictional treatment of §6226 provisions does not clash with TEFRA's scheme because tax law is generally not subject to equitable exceptions.[25]

Finally, while this Court has never addressed §6226, Congress has left undisturbed a long line of decisions strictly construing technical tax statutes and holding they are not subject to equitable considerations.[26] This lack of equity is a fundamental reason why tax laws, especially those involving jurisdiction, must be strictly construed. For example, where a statute uses jurisdictional language to expressly forbid a class of persons to be parties to or to participate in a suit, those persons should not later be bound to that suit.

This Court's guidance is needed to clarify that §§6226(a)-(g) and 6231(a)(3) (for purposes of §6226(f)) are jurisdictional under the *Arbaugh/Henderson* test and cannot be waived or altered.

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[24] *A.I.M. Controls*, 672 F.3d at 394-95.

[25] *A.I.M. Controls*, 672 F.3d at 394, citing *United States v. Brockamp*, 519 U.S. 347, 352, 117 S. Ct. 849, 136 L. Ed. 2d 818 (1997).

[26] See *Commissioner v. Gooch Milling & Elevator* Co., 320 U.S. 418, 422, 64 S. Ct. 184; 88 L. Ed. 139 (1943); *Lewyt Corp. v. Commissioner*, 349 U.S. 237, 249, 75 S. Ct. 736, 99 L. Ed. 1029(1955); *Helvering v. NW Steel Rolling Mills, Inc.*, 311 U.S. 46, 49, 61 S. Ct. 109, 85 L. Ed. 29(1940).

c. Judicial Review Under TEFRA

In TEFRA, Congress created three classes of "items"[27] and two levels of proceedings. An item's classification controls whether its tax treatment is determined at the *partnership* or *partner* level.

i. Classification

TEFRA classifies every item as either:

- a **partnership item**, which §6231(a)(3) narrowly defines as:

> any item required to be taken into account for the partnership's taxable year under any provision of subtitle A [§§1-1563] to the extent regulations prescribed by the Secretary provide that, for purposes of this subtitle [F, §§6001-7874], such item is more appropriately determined at the partnership level than at the partner level;

- a **nonpartnership item**, which §6231(a)(4) defines as "an item which is (or is treated as) not a partnership item"; or
- an **affected item**, which §6231(a)(5) defines as "any item to the extent such item is affected by a partnership item."

Partnership-*level* issues and partnership-*related* items are not *ipso facto* partnership items. Technical

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[27] An undefined term.

tax statutes are strictly construed.[28] For tax purposes, congressional definitions control, even if courts would otherwise conclude differently.[29] Consequently, only items "required to be taken into account . . . under . . . subtitle A" can qualify, and they only become partnership items if the Secretary properly designates them by regulation.[30] Treas.Reg. §301.6231(a)(3)-1 designates partnership items. Items the partnership takes into account under subtitle A are not partnership items even if they are more appropriately considered at the partner level *unless* they are properly designated.[31]

Treas. Reg. §301.6231(a)(3)-1(a)(4) clarifies that items and issues are partnership items only if the partnership can "conclusively" determine them at the partnership level without partner-specific facts. *Id.* at 191.

Items with partnership-item and nonpartnership-item elements are affected items, not partnership

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[28] *Lewyt Corp.*, 349 U.S. at 249; *NW Steel*, 311 U.S. at 49.

[29] *Sanford's Estate v. Commissioner*, 308 U.S. 39, 48, 60 S. Ct. 51; 84 L. Ed. 20 (1939); *Badaracco v. Commissioner*, 464 U.S. 386, 398, 104 S. Ct. 756; 78 L. Ed. 2d 549 (1984).

[30] Section 6231(a)(3) empowers the Secretary to designate partnership items from among an expressly prescribed universe. Nothing empowers the Secretary to *define* or re-define "partnership item." BUS:8.

[31] *Grigoraci v. Commissioner*, 84 T.C.M. (CCH) 186, 189 (2002).

items.[32]

Congress prescribes when an item's classification can change:

- Ten provisions prescribe when partnership items "become" or "shall be treated as" *non*partnership items;[33]
- §6231(a)(5) prescribes when and to what extent nonpartnership items may be treated as affected items;
- §6231(c)(2) empowers the Secretary to promulgate regulations identifying additional circumstances under which items "shall be treated as nonpartnership items."

Congress prescribes zero circumstances under which *non*partnership items or affected items become or shall be treated as partnership items. And nothing empowers the Secretary to do so by regulation.

ii. Judicial Review, Generally

In TEFRA, Congress enacted a two-tiered system of judicial review–at the partnership level *and* the partner level. Both levels must engage to function

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[32] *Affiliated Eqmt Leasing II v. Commissioner*, 97 T.C. 575, 578 (1991), citing *N.C.F. Energy Partners v. Commissioner*, 89 T.C. 741, 743-745 (1987) and *White v. Commissioner*, 95 T.C. 209, 212 (1990).

[33] §6223(e)(2), (e)(3)(B), §6227(c)(3)(pre-2002)/(d)(3)(post-2002), §6228(b)(1), (b)(2)(A)(ii), §6231(b)(1)(A)-(D), and (c)(2).

properly and effectuate the statutory language.[34]

Subject to numerous exceptions,[35] §6221 requires that "the tax treatment of any partnership item shall be determined at the partnership level."[36] Consequently, partnership items, including any partnership-item elements of affected items, are normally reviewed and determined first. §6226(a), (e). Unless expressly barred, all partners are parties to the partnership-level suit. §6226(c), (d).

After a partnership-level suit concludes, the Secretary applies any partnership-item adjustments or re-allocations to separately assess the resulting tax liability, if any, against each bound partner. §6225(a). That assessment is a "computational adjustment," which §6231(a)(6) defines as:

> the change in the tax liability of a partner which properly reflects the treatment under this subchapter [63C] of a partnership item.

Unless excepted, §6212(a) requires the Secretary to issue a deficiency notice before assessing against a

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[34] *Monti v. United States*, 223 F.3d 76, 82 (2d Cir. 2000); *Prochorenko v. United States*, 243 F.3d 1359, 1363 (Fed. Cir. 2001); *Field v. United States*, 328 F.3d 58 (2d Cir. 2003).

[35] *E.g.*, settlement or bankruptcy. §§6224(c)(1), 6231(c)(2) and Treas.Reg. §301.6231(c)-7.

[36] While not jurisdictional under *Henderson*'s factors, §6221 is mandatory. See generally, *Union Pacific R. Co. v. Locomotive Engineers and Trainmen Gen. Comm. of Adjustment, Central Region*, 130 S. Ct. 584, 596, 175 L. Ed. 2d 428 (2009).

taxpayer. Section 6230(a)(1) of TEFRA excepts the Secretary from issuing deficiency notices prior to most computational adjustments. But, §6230(a)(2)(A) reimposes that duty for "any deficiency attributable to . . . affected items which require partner level determinations (other than penalties, additions to tax, and additional amounts that relate to partnership items) . . ." (parenthetical not applicable for pre-1997 tax years).

Under TEFRA, penalties are quintessential affected items and virtually always require further partner-level determinations. BUS.11. Nevertheless, the 1997 amendment excepts post-1996 penalties from deficiency notice requirements if the assessment "reflects the treatment under this subchapter [63C] of a *partnership item*" (emphasis added). §§6230(a)(2)(A)(i), 6231(a)(6).

Assessing deficiencies that reflect the treatment of *affected items* that require partner-level fact findings can never be a §6231(a)(6) computational adjustment.

A partner's outside basis is an affected item that always requires partner-level determinations. BUS.32,34. It is irrational that Congress intended penalties to be imposed without deficiency notices based on affected-item changes that themselves require deficiency notices.

If a deficiency notice issues, the partner can sue in the Tax Court pre-assessment and pre-payment to raise her partner-level defenses. §6213(a).

If no deficiency notice issues and she can pay, she can seek a refund. If, as the United States contends,

§6230(c) controls, then *if* the Secretary sends a vague and undefined "notice of computational adjustment" (which the Secretary is not required to send), then the partner must pay in full and file her claim within six months of that notice, regardless of whether any liability has actually been assessed.

If the partner cannot pay in full within six months, then, under the United States' analysis, she can never claim a refund regardless of the magnitude of the overassessment, based on a defense or error in the computational adjustment. For example, where the Secretary erroneously assesses $500,000 against an elderly partner on a fixed income with total assets of $100,000 and after six months the Secretary seizes those assets, then the §6230(c) requirement to pay and file for refund within six months is a clear violation of her rights to substantive and procedural due process.

In theory, partners who cannot pay erroneous assessments can seek relief in administrative CDP hearings after liens are issued or levies threatened and appeal any adverse determination to the Tax Court. §§6320(c), 6330(d)(1). But that potential relief is problematic. The extent to which CDP hearings can review computational adjustments is unclear. The United States' analysis assumes that §6230(a)(1) denies partners all access to CDP hearings. If CDP hearings are available, they still do not cure the due process problem because they become available only when a lien issues or a levy is threatened, which is virtually always more than six months after assessment, while interest continues to accrue and a 1% per month failure to pay penalty is normally

imposed. If §6230(c) controls refund claims, then partners can only obtain their right, if any, to a CDP hearing by waiving and forfeiting their right to ever file a refund claim.

Further, without deficiency notices, partners who are forced to and can seek CDP relief actually increase the total administrative burden because they must pursue administrative hearings *before* appealing to the Tax Court, instead of going straight to the Tax Court via deficiency notices.

TEFRA's prescriptions for partner-level suits are consistent for all fora. Partner-level courts determine only nonpartnership items and affected items. Section 6221 (and §7422(h), if applicable) forbids them to determine *de novo* or redetermine partnership items.[37] To determine affected items, a partner-level court determines their nonpartnership-item elements and *applies* any partnership-item elements previously determined in a partnership-level suit to which *res judicata* binds that partner.[38] If a party bears the burden on a partnership-item element and failed to obtain that determination at the partnership-level, then that party loses that affected-item claim or defense.

Generally, when a tax statute limits a thing to be done in a particular mode, it includes the negative of

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[37] See also §6230(c)(4).

[38] *Dial USA, Inc. v. Commissioner*, 95 T.C. 1, 6 (1990).

any other mode.[39] And when Congress includes particular language in one section of TEFRA but omits it in another, it is generally presumed that Congress acts intentionally and purposely in that disparate inclusion or exclusion.[40]

"Attributable to" is not defined. For tax purposes, it means "due to, caused by, or generated by."[41] Further, it requires a direct causal relationship, even being "substantially related" is not enough.[42]

TEFRA specifies what must be "attributable to" what for each given context:

- **refund** attributable to . . . ;[43]

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[39] *Botany Worsted Mills v. United States*, 278 U.S. 282, 289 (1929).

[40] *Curr-Spec Partners., L.P. v. Commissioner*, 579 F.3d 391, 398 and n.33 (5th Cir. 2009); citing *A.D. Global Fund, LLC v. United States*, 481 F.3d 1351, 1354 (Fed.Cir.2007).

[41] *Keener v. United States*, 551 F.3d 1358 (Fed. Cir. 2009)

[42] *Stanford v. Commissioner*, 152 F.3d 450, 459 (5th Cir. 1998) ("attributable to" is strictly construed for §952(c)(1)(C)(i)); *Weiner*, 389 F.3d at 160-163 ("attributable to" narrowly construed for §6621(c) penalty interest); *Heasley v. Commissioner*, 902 F.2d 380, 383 (5th Cir. 1990) (underpayment must be solely "attributable to" §6659(a) valuation overstatement); *Alexander v. United States*, 44 F.3d 328, 331 (5th Cir. 1995) ("attributable to" in §7422(h) requires direct, not indirect, causal relationship). See also *Rigas v. United States*, 2012 U.S. App. LEXIS 17636, *20-*24 (5th Cir. Aug. 21, 2012) (unpublished) (§7422(h) cannot bar jurisdiction where refund not directly attributable to partnership item).

[43] §7422(h) and §6230(d) (shorthanded title only).

- **deficiency** attributable to . . . ;[44]
- **tax** attributable to . . . ;[45]
- **liability** attributable to . . . ;[46]
- **overpayment** attributable to . . . ;[47]
- . . . attributable to **partnership items**;[48]
- . . . attributable to **partnership items (and/or affected items)**;[49]
- . . . attributable to **affected items**;[50]
- . . . attributable to **nonpartnership items**;[51]

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[44] §6222(c)(2), §6225(a), §6230(a)(2)(A), (a)(2)(B), §6234(d)(2), (e)(3), (g)(1).

[45] §6226(d)(1)(B), §6228(a)(3)(C), §6229(a), (b)(3), (c)(1)(A), (c)(3), (e), (f)(1), (f)(2), §6230(d)(1), §6234(g)(2), (g)(4)(C).

[46] §6230(a)(3)(A), and (c)(5)(A).

[47] §6228(b)(1)(A), §6230(c)(1)(B), (d)(1)-(6).

[48] §6225(a), 6226(d)(1)(B), §6228(a)(3)(C), §6229(b)(3), §6230(d) (title), (d)(6), §6234(g)(4)(C), post-1997 §6230(d)(6), and §7422(h).

[49] §6229(a), (c)(1)(A), (c)(3), (e), §6230(d)(1)-(5), §6234(g)(2), pre-1997 §6230(d)(6)

[50] §6230(a)(2)(A)(i), §6234(d)(2), (g)(1).

[51] §6228(b)(1)(A).

- . . . attributable to [other][52].

Blurring the distinction between partnership items and affected items, introducing ambiguity into the requirement of a direct causal relationship between an issue and the item it is attributable to, and non-statutory denial of access to judicial review at either level are all contrary to and frustrate the carefully crafted system for separate treatment enacted in the statutory language.

Congress intended and enacted judicial review at both levels.[53] Partnership-level suits streamline the determination of common partnership items while numerous provisions protect the partners' due process rights. Partner-level suits protect the partners' rights and interests in their partner-level defenses while ensuring that partnership-item determinations are properly applied but not revisited.

iii. Scope of §6226
Before the 1997 Amendments

TEFRA is generally effective for all partnership tax years beginning after September 3, 1982. Many §6226 provisions were amended in 1997; therefore, the scope of §6226's jurisdictional grants and limits is determined by the tax year involved.

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[52] §6222(c)(2) (computational adjustment), §6229(f)(1) (converted/affected items), (f)(2) (settled items), §6230(a)(2)(B) (each partnership), (a)(2)(A), (c)(1)(B) (settlement, FPAA, decision), (c)(5)(A), and §6234(e)(3) (essentially nonpartnership items).

[53] See footnote 34.

> For pre-1997 tax years, §6226(f) states:
>
> (f) SCOPE OF JUDICIAL REVIEW.–A court with which a petition is filed in accordance with this section *shall have jurisdiction to determine all partnership items* of the partnership for the partnership taxable year to which the [FPAA] relates and the proper allocation of such items among the partners.

(Emphasis added.)

Section 6226(f) grants partnership-level jurisdiction only to adjust and allocate §6231(a)(3) "partnership items." Nothing grants partnership-level jurisdiction of any nonpartnership item or affected item.[54] Because §6226(f) is jurisdictional, its limits cannot be waived and its scope cannot be expanded. Correspondingly, because §6231(a)(3)'s narrow definition of "partnership item" limits §6226(f) jurisdiction, it is jurisdictional in that context and its requirements cannot be waived or altered.[55]

iv. Scope of Amended §6226

Section 6226(f)'s 1997 amendment granted new partnership-level jurisdiction of "the *applicability of* any penalty, addition to tax, or additional amount which relates to an adjustment to a partnership item"

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[54] *Grigoraci*, 84 T.C.M. at 189-91.

[55] As discussed in section 1.b above, every provision of §6226, except (h), is also jurisdictional.

(emphasis added).[56] This means that for post-1996 tax years, partnership-level courts can determine whether:

- any penalty, etc., that "relates to an *adjustment to a partnership item*" may apply; and
- as a matter of law, a penalty *cannot* apply if *grounded on that court's partnership-item determinations.*

Nothing in the 1997 amendments alters the definition of "partnership item" or converts affected items into partnership items. Nor does amended §6226(f) grant jurisdiction generally of nonpartnership items or affected items. In particular, they did not grant partnership-level jurisdiction of nonpartnership-item fact determinations, *i.e.*, to determine whether a penalty, etc., applies to specific partners and, if so, their liability. BUS:34-35. That aggressive interpretation would frustrate TEFRA's bifurcated scheme for review and render partnership-level suits unmanageable, and render inoperative or superfluous, void or insignificant the express reservation of each partner's right to assert his individual defenses in later partner-level proceedings.[57]

For post-1996 tax years, a partnership-level court's

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[56] Sections 6221 and 6230(a)(2)(A)(i) were similarly amended.

[57] *Corley v. United States*, 556 U.S. 303, 314, 129 S. Ct. 1558; 173 L. Ed. 2d 443 (2009) ("A statute should be construed so that effect is given to all its provisions, so that no part will be inoperative or superfluous, void or insignificant . . . ."), quoting *Hibbs v. Winn*, 542 U.S. 88, 101, 124 S. Ct. 2276, 159 L. Ed. 2d 172 (2004) (footnote and internal quotation marks omitted).

penalty jurisdiction is limited to cases where their application can be determined *as a matter of law* without regard to any partner-level facts and only if related to an adjustment to a partnership item, not an adjustment to an affected item that cannot occur until after the partnership-level suit concludes.

The issue of whether any partner-level fact findings are required to assess a resulting liability, if any, against a specific partner remains a nonpartnership item. Thus, after 1997, partnership-level courts still lack jurisdiction to determine whether §6230(a)(2)(A)(i) requires the Secretary to issue a deficiency notice. Partnership-level courts can now determine *whether* certain penalties, etc., may apply but they cannot determine the Secretary's later *method* of assessment.[58] For example, if IRS records reflect that a partner amended his return but the Secretary lost that information, then §6230(a)(2)(A)(i) requires the Secretary to issue a deficiency notice before assessing to determine, *inter alia*, whether the amended return removed some or all of the later-disallowed losses.

The United States argues that §6226(f)'s amended language should be judicially expanded to abrogate the Secretary's §6230(a)(2)(A)(i) duty to issue deficiency notices. BUS.10-11, 28-29, 37-38. It erroneously rationalizes that this would reduce the Secretary's

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[58] Partnership-level courts are not required to identify the partners bound to the outcome of the suit. Identity of the partners is either a partnership item or a nonpartnership item depending on the facts. *Grigoraci*, 84 T.C.M. at 189-91.

administrative burden and lighten the Tax Court's docket. But if a partner disputes the *application* of partnership-item adjustments in later determining his liability, then forcing her to pursue the questionable alternative remedies (discussed on pp. 18-20) ultimately results in a greater administrative burden than simply issuing deficiency notices, and severely diminishes the partner's right to redress of erroneous computational adjustments.

v. Section 6226(f) Partnership-Level Jurisdiction of Penalties

Section 6226(f) grants jurisdiction of partnership items, including partnership-item elements of affected items for all TEFRA tax years. For tax year 1999, amended-§6226(f) granted the district court jurisdiction of "the *applicability of* any penalty" but *not* of any nonpartnership-item, partner-level fact findings required to impose any penalty directly on a partner. No penalty based on a deficiency due to a partner's overstatement of her outside basis can be determined until after her outside basis is determined and a resulting deficiency exists.[59]

Amended §6226(f) granted the district court jurisdiction only to determine:

- whether the entire COBRA transactions lacked economic substance such that the *partnerships* should be disregarded as shams and, potentially, any deductions claimed on the

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[59] *Petaluma FX Partners, LLC v. Commissioner*, 591 F.3d 649, 654-56 (D.C. Cir. 2010).

partnership returns disallowed;[60] and

- that the §6662 SVM penalty *is not applicable* to the partners as a matter of law *based on those disallowances*, because precedent holds that any resulting underpayment is attributable to claiming an improper deduction and not to any valuation overstatement purportedly included in that now totally disallowed deduction;[61] or
- that it has no jurisdiction of the asserted penalties.

Res judicata binds all parties to those determinations, if upheld. After this partnership-level suit concludes, the IRS is free to impose §6662 SVM penalties on any partner against whom it has nonpartnership-item grounds or against whom it otherwise obtained partnership-item grounds, *e.g.*, by individual settlement. §6224(c)(1). Those partners can raise their partner-level defenses in a partner-level proceeding where the partnership-item determinations are applied but not revisited. §§6230(c)(4), 7422(h).

Generally, the district court had jurisdiction to hold that its partnership-item determinations *could not* apply/impose the §6662 SVM penalty on *any* bound partner as a matter of law. But it had no jurisdiction to apply/impose the §6662 SVM penalty directly on any

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[60] *Woods v. United States*, 794 F.Supp.2d 710, 713 (W.D.Tex. 2010).

[61] *Woods v. United States*, 794 F.Supp.2d 714, 717 (W.D.Tex. 2011), citing *Heasley*, 902 F.2d at 383.

partner because that requires partner-level fact determinations it cannot make. The most it could do to assist the Secretary in imposing the §6662 SVM penalty, or any other, was to:

- make partnership-item determinations, and
- determine whether and to what extent those partnership-item determinations could later make a specific penalty applicable.

6611, Ltd. provides a recent example from the Tax Court.

The Secretary can later rely on those determinations to impose any such penalty at the partner level. But on the facts of *Woods* here, no such determinations were available or made. See the discussion on pp. 35-38.

The United States overreaches in arguing that the §6662 SVM penalty proposed here "relates to an adjustment to a partnership item." BUS.22, 31-32. Tax statutes are strictly and narrowly construed. Respondent is correct that on these facts the "adjustment" that purportedly triggers the §6662 SVM penalty is the adjustment to each partner's outside basis, which may be a *nonpartnership* item or an *affected* item, but is never a partnership item. Further, partnership-level courts can hardly have jurisdiction to impose a penalty when they have no jurisdiction to make the adjustment that purportedly triggers that penalty.

The United States invites this Court to circumvent the statutory definition of "partnership item" and

adopt its position (discussed above as to "attributable to") that affected items are treated as partnership items because they would not exist but for partnership items. That invitation should be declined, as it was by other courts that declined to create a judicial "but for" test that would undermine Congressional intent that partnership items and affected items be treated differently.[62]

vi. The Effective Dates of the 1997 Amendments

This Court's opinion will impact the jurisdictional analyses of all partnership-related cases of all tax years.

The partnership-level suits relevant to the *amici*'s suits were pending for years before the 1997 amendments, some of which Congress made retroactive to TEFRA's 1982 enactment[63] and others it made prospective only.[64] Every §6226 amendment was prospective, effective for tax years ending after August

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[62] See *United States v. Steinbrenner*, 2013 U.S.Dist. LEXIS 80290, *11-*16 (M.D.Fla. June 7, 2013) and cases cited therein.

[63] See §6230(a), (a)(1), and (c). Taxpayer Relief Act of 1997 (TRA 1997), P.L. 105-34, §§1237(a), (b), and (c)(1).

[64] §6226(d)(1)(B) and (f). TRA 1997, P.L. 105-34, §1238(b)(1)(A)-(B) and §1239(b); see also §6221, §6225(b), §6230(a)(2)(A)(i), (3)(A), (a)(3)(B), (c)(1), (c)(2)(A), (c)(4), (c)(5)(A), (c)(5)(D), (d)(6), §6231(a)(1)(B)(i), (g), and §6234. TRA 1997, P.L. 105-34, §1232(a), §1234(a), §1238(a), (b)(2), (b)(3)(A), (b)(3)(B), (b)(3)(C), (b)(3)(D), (b)(4), (b)(5), (b)(6), and §1239(a), (c)(1).

5, 1997.[65]

Some courts hold that *amici* and similarly situated partners waived or forfeited their limitations and penalty interest defenses because they did raise those issues in the partnership-level suits, *i.e.*, that the pre-1997 §6226(d)(1)(B) and (f) threshold limits on partnership-level personal and subject matter jurisdiction are nonjurisdictional and may be waived or altered. Some also hold that the 1997 amendments merely codified the Tax Court's prior practice, thus treating the effective dates of the 1997 amendments as nonjurisdictional and rendering pre-1997 §6226(d)(1)(B) meaningless.[66]

Effective dates are neither meaningless nor optional.[67] The Tax Court holds it cannot ignore the TRA 1997 effective dates.[68] Retroactivity to circumvent express effective date is impermissible.[69]

Under *Henderson*'s factors, the 1997 §6226

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[65] Except the amendment to §6226(b), which was made effective for petitions filed after August 5, 1997. TRA 1997, P.L. 105-34, §1238(b)(1)(A)-(B).

[66] *Prati*, 603 F.3d at 1307-08 and n.4.

[67] *Lockheed Corp. v. Spink*, 517 U.S. 882, 896-97, 116 S. Ct. 1783; 135 L. Ed. 2d 153 (1996).

[68] *Ochsner v. Commissioner*, T.C.Memo 2010-122, 2010 WL 2220305, *5; *Williams v. Commissioner*, T.C.Memo 2009-158, 2009 WL 1884150, *2.

[69] *Landgraf v. USI Film Prods.*, 511 U.S. 244, 265, 114 S. Ct. 1483; 128 L. Ed. 2d 229 (1994).

amendments *and* their effective dates are jurisdictional and cannot be waived or altered. While this Court need not resolve the specific limits of pre-1997 partnership-level jurisdiction here, guidance as to whether the *test* for a statute's jurisdictional character also applies to that statute's effective date would reduce both litigation below and future petitions to this Court.

To hold, or even imply by silence, that the 1997 §6226 amendments apply for pre-1997 tax years would circumvent clear congressional intent, invite more confusion, and leave taxpayers like *amici* in a continuing quagmire of conflicting rulings on the jurisdictional character of §6226 provisions.

Amici urge this Court, at a minimum and as appropriate, to clarify that the §6226 provisions, except (h), are jurisdictional and that no inferences should be drawn *sub silentio* as to whether or how its jurisdictional analyses and holdings here apply for pre-1997 tax years.

d. Section 6226(f) Jurisdictional Consequences of Sham Determination

There are critical jurisdictional consequences to the district court's "sham" ruling that:

> [T]he [relevant] "transaction" . . . is the Plaintiff's use of two partnerships with a six-week life span to conduct . . . trading for the sole purpose of generating a paper loss. . . . The "Tinker to Evers to Chance" routine . . . (the transfer of assets from individuals to LLCs to partnerships to Subchapter S

> corporations) was not "compelled or encouraged by business or regulatory realities," nor was it "imbued with tax independent considerations." . . . It was totally lacking in economic substance and was for the sole purpose of creating a tax benefit.

Woods, 794 F.Supp.2d at 713 (citations omitted).

The parties agree the district court meant the partnerships themselves were shams.[70]

Neither party addresses that holding's jurisdictional consequences. Presumably, but for §6233, the district court had no jurisdiction. The United States argues that §6233 resolves this threshold problem because filing a partnership return subjects that return and persons who would be partners under §6226(c), (d), to TEFRA procedures, even if there is no

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[70] This is consistent with the FPAA determinations that:

> 2. . . .Accordingly, the partnership and the transactions described above shall be disregarded in full and any purported losses resulting from these transactions are not allowable as deductions for federal income tax purposes.
>
> . . . .
>
> 3. . . . .
>
> a. SA Tesoro Investments Partners is disregarded and that all transactions engaged in by the purported partnership are treated as engaged in directly by its purported partners.

See Plaintiffs' Trial Exhibit 178 (*Woods*, WDTX 05-216) (SATIP FPAA). See also Plaintiffs' Trial Exhibit 177 (TD Partners FPAA).

partnership.

But how to implement §6233 is unclear. *Amici* would argue that when a court holds a partnership is a sham to be disregarded for tax purposes, the rational application of §6233 is for the court to then enter *that* decision as the totality of its holdings. If the partnership is to be disregarded for tax purposes, the next step should be for the Secretary to pursue partner level deficiency procedures. If there is no recognition of the partnership, there are no "partnership items" to be determined, and all transactions should be treated as conducted directly by the partners. This resolves all of the otherwise grossly complex issues plaguing this case.

The Tax Court recently took a different approach to applying §6233 to a disregarded partnership. In *6611, Ltd.*, it explained its treatment of §6233 thusly:

> The Code tells us that TEFRA procedures will still apply in these cases as long as the purported partnership filed a partnership return . . . . This means we have to determine in these cases any items that would have been "partnership items," . . . had [the partnerships] been valid partnerships for tax purposes. . . . This is the "hypothetical entity" approach. . . .

6611, Ltd, at *P62.

However, the Tax Court clarified that the substantive partnership tax law of subchapter K *does not apply* (*i.e.*, it would apply non-partnership substantive law at the "hypothetical" partnership level). *Id.* at *P61. *Amici* can find no appellate opinions

on the issue and would argue that theirs is the better approach (applying non-partnership substantive law at the partner level).

But even under the Tax Court approach to §6233, which appears to be the approach adopted by the district court here, nothing in §6226(f) gave the district court partnership-level jurisdiction to make determinations *beyond* the bounds of the partnership returns before it. By holding the transactions to be shams, the district court did not somehow expand its jurisdiction to disallow deductions (capital losses and ordinary losses) presumed to have been ultimately claimed by the putative partners **but not claimed by the partnership at all**. Based on the district court's fact findings, those deductions were simply presumed to have been claimed by the S corporations after the partnership was terminated.

Specifically, the district court found:

> As the year 1999 was coming to a close, both partnerships transferred all their remaining assets to the two Subchapter S corporations, effectively resulting in the liquidation of the partnerships. . . . Tesoro Drive Investors, Inc. sold the Canadian Dollars, which Woods and McCombs claimed resulted in an ordinary loss for tax purposes of $13,353,162.00. SA Tesoro Investors, Inc. sold the remaining shares of Sun Microsystems stock, which, according to Woods and McCombs, resulted in a short-term capital loss for tax purposes in the amount of $32,297,786. . . . .

Thus, based on the district court's own findings, the purported losses were incurred and claimed by the S corporations, **not the partnerships**. They were not deductions ever claimed on the partnership returns, and under no possible §6226(f)/§6233 analysis were they "partnership items," even of any "hypothetical partnership."

The district court decision did not specifically disallow the deductions by Woods and McCombs, but only provided:

> It is therefore ORDERED that the Defendant's motion for judgment as a matter of law with respect to the disallowance of the ordinary and capital losses claimed on the partnership returns in this case be, and it is hereby, GRANTED.

Woods, 794 F.Supp.2d at 714 (emphasis in original).

The FPAAs disallowed **no** ordinary or capital losses. In fact, the FPAAs favorably determined for SA Tesoro Investment Partners (SATIP) a reduction in ordinary income of $50,000 and a reduction in interest income of $958, and for Tesoro Drive Partners (TDP) a reduction in ordinary income of $650,000 and a reduction in short term capital gains of $5,037.[71] There simply were NO "ordinary and capital losses claimed on the partnership returns," to be treated as partnership items.

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[71] See Plaintiffs' Trial Exhibit 178 (*Woods*, WDTX 05-216) (SATIP FPAA). See also Plaintiffs' Trial Exhibit 177 (TD Partners FPAA)

The district court opinion rendered no valuation decision or specific determinations as to basis. Any such determinations in the FPAAs were extinguished and deemed conceded when the United States failed to pursue them by defending any such FPAA adjustments.[72]

The district court simply had no jurisdiction under §6226(f) to determine whether deductions claimed by two S corporations and their shareholders were proper, and it did not do so.

It also had no jurisdiction to conclude there were any penalties (negligence, substantial understatement, or overvaluation) attributable to those nonexistent partnership-item adjustments.

Under *amici*'s approach to §6233, the district court had no jurisdiction under §6226(f) to determine the applicability of any SVM penalty if there was no partnership recognized for tax purposes. Nor under the "hypothetical partnership" approach could it determine a SVM penalty applied where no basis or valuation determinations were made and no actual partnership deductions disallowed.

The holding that the entire COBRA investment scheme lacked economic substance would nevertheless be binding on the parties and would be *res judicata* in any later proceedings at the individual taxpayer (purported partner) level. If this Court adopts the "hypothetical partnership" approach to §6233, then any

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[72] *Rovakat, LLC v. Commissioner*, T.C.Memo 2011-225 *P41 n.22 (conceding on brief by failing to defend FPAA adjustments).

"partnership item" determinations regarding the returns of the "hypothetical partnerships" would similarly be *res judicata* as to these parties.

However, it is nonsensical to hold that as to penalties the district court had §6226(f) jurisdiction based on (i) its findings that the partnerships were to be disregarded as shams, (ii) the FPAAs' reduction of income and gains reported by the partnerships, and (iii) the Court's sole determination to disallow a category of deductions never claimed by the partnership.

Amici urge the Court to rule, based on the district court's fact findings, that the district court lacked jurisdiction under §6226(f) to determine the applicability of any SVM penalty.

2. The Blue Book Formula Implements §6662's Statutory Text and Complements Treas.Reg. §301.6621-2T, A-5

Section 6662(b) provides:

> (b) PORTION OF UNDERPAYMENT TO WHICH SECTION APPLIES.–This section shall apply to *the portion* of any underpayment which is attributable to 1 or more of the following:
>
> (1) Negligence or disregard of rules or regulations.
>
> (2) Any substantial understatement of income tax.
>
> (3) Any substantial valuation

misstatement under chapter 1.

. . . .

(Emphasis added).

The statute does not provide, and the Secretary has never promulgated, any formula to calculate the portion of a taxpayer's underpayment subject to the §6662 SVM penalties. Therefore, to determine that portion, in 1988 the Fifth Circuit in *Todd* turned to the Blue Book formula,[73] under which the amount subject to the substantial valuation penalty is the portion left "*after* taking into account any other proper adjustments to tax liability." This is consistent with the Fifth Circuit's interpretation of §6662(b)'s plain language: §6662(b)(1)-(3) penalties are imposed in the alternative, not cumulatively.[74]

The Fifth Circuit recognizes:

> [P]enalties under §6662 must be applied alternatively, not cumulatively, only one of the penalties assessed may be sustained–***they cannot be stacked***. See *Southgate*, 659 F.3d at 492 n.81; *Bemont*, 679 F.3d at 346.

Nev. Partners Fund, L.L.C. v. United States, 2013 U.S. App. LEXIS 12877, *50-*52 (5th Cir. June 24, 2013)

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[73] *Todd v. Commissioner*, 862 F.2d 540, 542-45 (5th Cir. 1988), holding that the Blue Book "formula . represents Congress' intent for determining whether to impose the §6659 [later replaced by §6662] addition to tax in any given case."

[74] *Southgate Master Fund, L.L.C. v. United States*, 659 F.3d 466 (5th Cir. 2011).

(emphasis added).

However, the United States would apply the §6662 SVM penalty to 100% of the underpayment where the deductions are disallowed for lack of economic substance. This disregards the fact that if the disallowance were purely based on overvaluation (or overstated basis if the Court finds that is encompassed by the penalty), it would allow a deduction for the correct value or basis, even if it was only a fraction of the total deduction claimed. At a minimum, *that* portion of the disallowance is not based on an actual overvaluation of basis at all. An accurate determination of the applicable "portion" is essential under the statute and cannot be made in this partnership-level suit.

The government has had 25 years (at least since *Todd*) to convince the Secretary to promulgate by regulation a formula it deems consistent with the statute. It has not.

However, in 1984, the Secretary did promulgate a formula in Treas.Reg. §301-6621-2T, A-5, substantively similar to the Blue Book formula, to calculate the portion of a taxpayer's underpayment subject to penalty interest.

"Penalty" interest under former §6621(c) allows the Secretary to impose interest at 120% of the normal rate on any "substantial underpayment" "attributable to" one of the TMTs listed in §6621(c)(3)(A) or Treas.Reg. §301.6621-2T. It and other penalties were quickly repealed in 1989 because Congress found they were "determined too routinely and automatically by the

IRS"[75] and were a "morass of inconsistency and irrationality" that discouraged rather than encouraged compliance and under which a "hapless taxpayer [could] find himself, or herself, confronting the [I.R.C.] over a tax deficiency, where the penalties and interest have been piled on to the extent that they are twice [200% of] the amount of tax in dispute."[76] Despite its repeal in 1989, that "draconian" interest provision continues to dog taxpayers for returns filed in the 1980s.[77]

All *amici* have penalty interest claims.

The Fifth Circuit uses *Todd*'s Blue Book analysis as a "conceptual lens through which to view the statutory phrase 'attributable to' [and Treas.Reg. §301.6621-2T, A-5] in the context of §6621(c)" and hold that under that regulatory formula, if an underpayment is attributable to two grounds, one TMT and one non-TMT, then the portion attributable to the non-TMT is subtracted from the whole *first* and the portion left is subject to penalty interest. *Weiner*, 380 F.3d at 159-163.

In contrast, without finding the regulation invalid

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[75] H. Rep. No. 101-247, 101st Cong. 1041, 1388, 1393, 1394 (1989).

[76] Statement by Senator Pryor introducing S.1784 at 135 Cong. Rec. S13893-7 (Oct. 24, 1989).

[77] *Weiner*, 389 F.3d at 159.

or addressing *Chevron* deference,[78] the Federal Circuit authorizes the Secretary to simply disregard Treas.Reg. §301.6621-2T, A-5, because applying its formula would "invalidate the [TMT] determination."[79]

Two panel members of the Fifth Circuit recently joined Judge Prado's concurrence to question the Blue Book formula.[80] The United States is now relying on that concurrence in trying to convince the Fifth Circuit that the IRS should be allowed to disregard Treas.Reg. §301.6621-2T, A-5 there as it does in the Federal Circuit.[81] *Amici* counter that if the IRS does not like its own regulation, it should not have promulgated it.

While the Court's analysis of the Blue Book's formula will not control *amici*'s penalty interest claims, it will be persuasive on the lower court's interpretation of Treas.Reg. §301.6621-2T, A-5's similar formula.

The overbroad interpretation of penalty statutes requested by the United States may seem justified in a specific case, but it becomes egregious where taxpayers like *amici* were limited partners and the Secretary relies entirely on partnership-level actions

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[78] *Chevron U.S.A. Inc. v. N.R.D.C., Inc.*, 467 U. S. 837, 104 S. Ct. 2778, 81 L. Ed. 2d 694 (1984).

[79] *Prati*, 603 F.3d at 1308.

[80] *Bemont Invs., L.L.C. v. United States*, 679 F.3d 339, 351-55 (5th Cir. 2012) (concurring).

[81] See n. 14 on pp. 62-63 of the Brief for the Appellee at Doc. 00512139781 filed on February 8, 2013, in *Irvine, et al.* (5th Cir. 12-20523)

taken without their knowledge and in which they, as limited partners, could not participate. Thirty years after their ill-fated investments, many are now on fixed incomes. While there is no equity in tax law, there is no compelling reason to broadly interpret severe penalties, especially in a procedural setting where the penalized persons have extremely limited and constitutionally doubtful avenues of redress in which to raise defenses to or errors in computational adjustments.

CONCLUSION

Before the Court's jurisdictional question be answered, the test for the jurisdictional character of tax statutes must be determined. *Arbaugh* and *Henderson* establish a broad general test for the jurisdictional character of all federal statutes, unless a specific test applies. There is no specific test for tax statutes. This Court's guidance is needed to clarify that the *Arbaugh/Henderson* test applies to tax statutes generally and to §6226 provisions specifically. Under that test, §6226(a)-(g) are jurisdictional and cannot be waived or altered for any tax year subject to TEFRA.

On the facts of this case, §6226(f) did not confer jurisdiction on the district court to determine a §6662 SVM penalty where no relevant partnership-item determinations were made.

If this Court determines the district court did have jurisdiction over the penalty, the denial of the applicability of that penalty should be sustained.

Respectfully submitted.

Thomas E. Redding
Counsel of Record
Sallie W. Gladney
Redding & Associates, P.C.
2916 West T.C. Jester, Suite 102
Houston, TX 77018
(713) 965-9244
Counsel for Amici Curiae

JULY 2013

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Addendum A

The *amici* who are plaintiffs-appellants in *Bush v. United States*, 2013 U.S.App.LEXIS 10879 (Fed. Cir. 2013), where a petition for rehearing is currently pending before the Court of Appeals for the Federal Circuit (Fed.Cir. 12-5051), are:

Gordon W. Bush,
Reola Bush,
Barbara V. Catuzzi,
Lawrence R. Catuzzi,
Gordon R. Cooke,
Jennifer L. Cooke,
Gopala K. Derebail,
Memalatha Derebail,
Albert V. Gude,
Donna C.gude,
Lawrence S. Lewin,
Catherine D. Mcquillan,
Robert V. Mcquillan,
Jeanette T. Nakahara (Deceased),
Kikuo Nakahara,
Leslie A. Spitzack,
Mary C. Spitzack,
Barry S. Strauch, and
Evelyn M. Strauch.

Addendum B

The *amici* who are plaintiffs-appellants in the appeal of *Irvine v. United States*, 2012 U.S. Dist. LEXIS 60083 (S.D. Tex. 2012), currently pending before the Court of Appeals for the Fifth Circuit (5th Cir. 12-20523), are:

John A. Irvine,
Lynda Irvine,
Kenneth L. Kramer,
Billy J. White, and
Ina J. White.

Addendum C

The *amici* who are plaintiffs-appellants in the appeal of *Acute Care Specialists II, Ltd. v. United States*, 2011 U.S. Dist. LEXIS 144155 (N.D. 2011), currently pending before the Court of Appeals for the Seventh Circuit (7th Cir. 12-1212), are:

Acute Care Specialists II, Ltd.,
Gregory W. Jackson,
Nora A. Jackson,
Alan W. Kaplan,
Marcia Kaplan,
Anthony C. Raccuglia,
Judith A. Raccuglia,
Joann Shanahan, and
Joseph Shanahan.

Addendum D

The *amici* who are plaintiffs-appellants in *Fillmore Equip. of Holland, Inc., et. al v. United States*, 2013 U.S. App. LEXIS 12511 (Fed. Cir. 2013), who anticipate that they will shortly file a petition for writ of certiorari in this Court, are:

Fillmore Equipment of Holland, Inc.,
John A. Prag,
Lynn E. Prag,
Donald C. Stecker, and
Elise Stecker.

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SEC. 6221. TAX TREATMENT DETERMINED AT PARTNERSHIP LEVEL

Except as otherwise provided in this subchapter, the tax treatment of any partnership item shall be determined at the partnership level.

SEC. 6226. JUDICIAL REVIEW OF FINAL PARTNERSHIP ADMINISTRATIVE ADJUSTMENTS

(a) PETITION BY TAX MATTERS PARTNER.—Within 90 days after the day on which a notice of a final partnership administrative adjustment is mailed to the tax matters partner, the tax matters partner may file a petition for a readjustment of the partnership items for such taxable year with—

(1) the Tax Court,

(2) the district court of the United States for the district in which the partnership's principal place of business is located, or

(3) the Claims Court.

(b) PETITION BY PARTNER OTHER THAN TAX MATTERS PARTNER—

(1) IN GENERAL.—If the tax matters partner does not file a readjustment petition under subsection (a) with respect to any final partnership administrative adjustment, any notice partner (and any 5-percent group) may, within 60 days after the close of the 90-day period set forth in subsection (a),

file a petition for a readjustment of the partnership items for the taxable year involved with any of the courts described in subsection (a).

(2) PRIORITY OF THE TAX COURT ACTION.—If more than 1 action is brought under paragraph (1) with respect to any partnership for any partnership taxable year, the first such action brought in the Tax Court shall go forward.

(3) PRIORITY OUTSIDE THE TAX COURT.—If more than 1 action is brought under paragraph (1) with respect to any partnership for any taxable year but no such action is brought in the Tax Court, the first such action brought shall go forward.

(4) DISMISSAL OF OTHER ACTIONS.—If an action is brought under paragraph (1) in addition to the action which goes forward under paragraph (2) or (3), such action shall be dismissed.

(5) TAX MATTERS PARTNER MAY INTERVENE. The tax matters partner may intervene in any action brought under this subsection.

(c) PARTNERS TREATED AS PARTIES.—If an action is brought under subsection (a) or (b) with respect to a partnership for any partnership taxable year—

(1) each person who was a partner in such partnership at any time during such year shall be treated as a party to such action, and

(2) the court having jurisdiction of such action shall allow each such person to participate in the action.

(d) PARTNER MUST HAVE INTEREST IN OUTCOME.—

(1) IN ORDER TO BE PARTY TO ACTION.—Subsection (c) shall not apply to a partner after the day on which—

(A) the partnership items of such partner for the partnership taxable year became nonpartnership items by reason of 1 or more of the events described in subsection (b) of §6231, or

(B) the period within which any tax attributable to such partnership items may be assessed against that partner expired.

(2) TO FILE PETITION.—No partner may file a readjustment petition under subsection (b) unless such partner would (after the application of paragraph (1) of this subsection) be treated as a party to the proceeding.

(e) JURISDICTIONAL REQUIREMENT FOR BRINGING ACTION IN DISTRICT COURT OR CLAIMS COURT.—

(1) IN GENERAL.—A readjustment petition under this section may be filed in a district court of the United States or the Claims Court only if the partner filing the petition deposits with the Secretary, on or before the day the petition is filed, the amount by which the tax liability of the partner would be increased if the treatment of partnership items on the partner's return were made consistent with the treatment of partnership items on the partnership return, as adjusted by the final partnership administrative adjustment. In the case

of a petition filed by a 5-percent group, the requirement of the preceding sentence shall apply to each member of the group. The court may by order provide that the jurisdictional requirements of this paragraph are satisfied where there has been a good faith attempt to satisfy such requirements and any shortfall in the amount required to be deposited is timely corrected.

* * * *

(f) SCOPE OF JUDICIAL REVIEW.—A court with which a petition is filed in accordance with this section shall have jurisdiction to determine all partnership items of the partnership for the partnership taxable year to which the notice of final partnership administrative adjustment relates and the proper allocation of such items among the partners.

(g) DETERMINATION OF COURT REVIEWABLE. Any determination by a court under this section shall have the force and effect of a decision of the Tax Court or a final judgment or decree of the district court or the Claims Court, as the case may be, and shall be reviewable as such. With respect to the partnership, only the tax matters partner, a notice partner, or a 5-percent group may seek review of a determination by a court under this section.

(h) EFFECT OF DECISION DISMISSING ACTION. If an action brought under this section is dismissed (other than under paragraph (4) of subsection (b)), the decision of the court dismissing the action shall be considered as its decision that the notice of final partnership administrative adjustment is correct, and

an appropriate order shall be entered in the records of the court.

SEC. 6230. ADDITIONAL ADMINISTRATIVE PROVISIONS

(a) COORDINATION WITH DEFICIENCY PROCEEDINGS.—

(1) IN GENERAL.—Except as provided in paragraph (2), subchapter B of this chapter shall not apply to the assessment or collection of any computational adjustment.

(2) DEFICIENCY PROCEEDINGS TO APPLY IN CERTAIN CASES.—

(A) Subchapter B shall apply to any deficiency attributable to—

(i) affected items which require partner level determinations, or

(ii) items which have become nonpartnership items and are described in §6231(e)(1)(B).

* * * *

(c) CLAIMS ARISING OUT OF ERRONEOUS COMPUTATIONS, ETC.—

(1) IN GENERAL.—A partner may file a claim for refund on the grounds that—

(A) the Secretary erroneously computed any computational adjustment necessary—

(i) to make the partnership items on the partner's return consistent with the treatment of the partnership items on the partnership return . . . .

* * * *

(2) TIME FOR FILING CLAIM.

(A) Under paragraph (1)(A).— Any claim under subparagraph (1)(A) shall be filed within 6 months after the day on which the Secretary mails the notice of computational adjustment to the partner.

* * * *

(3) SUIT IF CLAIM NOT ALLOWED.—If any portion of a claim under paragraph (1) is not allowed, the partner may bring suit with respect to such portion within the period specified in subsection (a) of section 6532 (relating to periods of limitations on refund suits).

(4) NO REVIEW OF SUBSTANTIVE ISSUES. For purposes of any claim or suit under this subsection, the treatment of partnership items on the partnership return, under the settlement, under the final partnership administrative adjustment, or under the decision of the court (whichever is appropriate) shall be conclusive.

* * * *

SEC. 6231. DEFINITIONS AND SPECIAL RULES

(a) DEFINITIONS.—For purposes of this subchapter—

* * * *

(3) PARTNERSHIP ITEM.—The term "partnership item" means, with respect to a partnership, any item required to be taken into account for the partnership's taxable year under any provision of subtitle A to the extent regulations prescribed by the Secretary provide that, for purposes of this subtitle, such item is more appropriately determined at the partnership level than at the partner level.

(4) NONPARTNERSHIP ITEM.—The term "nonpartnership item" means an item which is (or is treated as) not a partnership item.

(5) AFFECTED ITEM.—The term "affected item" means any item to the extent such item is affected by a partnership item.

(6) COMPUTATIONAL ADJUSTMENT.—The term "computational adjustment" means the change in the tax liability of a partner which properly reflects the treatment under this subchapter of a partnership item. All adjustments required to apply the results of a proceeding with respect to a partnership under this subchapter [63C] to an indirect partner shall be treated as computational adjustments.

* * * *

SEC. 6233. EXTENSION TO ENTITIES FILING PARTNERSHIP RETURNS, ETC.

(a) GENERAL RULE.—If a partnership return is filed by an entity for a taxable year but it is determined that the entity is not a partnership for such year, then, to the extent provided in regulations, the provisions of this subchapter are hereby extended in respect of such year to such entity and its items and to persons holding an interest in such entity.

(b) SIMILAR RULES IN CERTAIN CASES.—If a partnership return is filed for any taxable year but it is determined that there is no entity for such taxable year, to the extent provided in regulations, rules similar to the rules of subsection (a) shall apply.

SEC. 6221. TAX TREATMENT DETERMINED AT PARTNERSHIP LEVEL

Except as otherwise provided in this subchapter, the tax treatment of any partnership item (and the applicability of any penalty, addition to tax, or additional amount which relates to an adjustment to a partnership item) shall be determined at the partnership level.

SEC. 6226. JUDICIAL REVIEW OF FINAL PARTNERSHIP ADMINISTRATIVE ADJUSTMENTS.

* * * *

(b) PETITION BY PARTNER OTHER THAN TAX MATTERS PARTNER.—

* * * *

(5) TREATMENT OF PREMATURE PETITIONS.—If—

(A) a petition for a readjustment of partnership items for the taxable year involved is filed by a notice partner (or a 5-percent group) during the 90-day period described in subsection (a), and

(B) no action is brought under paragraph (1) during the 60-day period described therein with respect to such taxable year which is not dismissed,

such petition shall be treated for purposes of paragraph (1) as filed on the last day of such 60-day period.

* * * *

(d) PARTNER MUST HAVE INTEREST IN OUTCOME.—

(1) IN ORDER TO BE PARTY TO ACTION.—Subsection (c) shall not apply to a partner after the day on which—

> (A) the partnership items of such partner for the partnership taxable year became nonpartnership items by reason of 1 or more of the events described in subsection (b) of §6231, or (B) the period within which any tax attributable to such partnership items may be assessed against that partner expired.

Notwithstanding subparagraph (B), any person treated under subsection (c) as a party to an action shall be permitted to participate in such action (or file a readjustment petition under subsection (b) or paragraph (2) of this subsection) solely for the purpose of asserting that the period of limitations for assessing any tax attributable to partnership items has expired with respect to such person, and the court having jurisdiction of such action shall have jurisdiction to consider such assertion.

(2) TO FILE PETITION.—No partner may file a readjustment petition under subsection (b) unless such partner would (after the application of paragraph (1) of this subsection) be treated as a party to the proceeding.

* * * *

(f) SCOPE OF JUDICIAL REVIEW.—A court with which a petition is filed in accordance with this section shall have jurisdiction to determine all partnership items of the partnership for the partnership taxable year to which the notice of final partnership administrative adjustment relates, the proper allocation of such items among the partners, and the applicability of any penalty, addition to tax, or additional amount which relates to an adjustment to a partnership item.

SEC. 6230. ADDITIONAL ADMINISTRATIVE PROVISIONS.

* * * *

(a) COORDINATION WITH DEFICIENCY PROCEEDINGS.—

* * * *

(3) SPECIAL RULE IN CASE OF ASSERTION BY PARTNER'S SPOUSE OF INNOCENT SPOUSE RELIEF.—

* * * *

(B) If the spouse files a petition with the Tax Court pursuant to §6213 with respect to the request for abatement described in subparagraph (A), the Tax Court shall only have jurisdiction pursuant to this section to determine whether the requirements of §6015 have been satisfied. For purposes of such determination, the treatment of partnership

items (and the applicability of any penalties, additions to tax, or additional amounts) under the settlement, the final partnership administrative adjustment, or the decision of the court (whichever is appropriate) that gave rise to the liability in question shall be conclusive.

* * * *

(c) CLAIMS ARISING OUT OF ERRONEOUS COMPUTATIONS, ETC.—

* * * *

(5) RULES FOR SEEKING INNOCENT SPOUSE RELIEF.—

* * * *

(D) PRIOR DETERMINATIONS ARE BINDING.—For purposes of any claim or suit under this paragraph, the treatment of partnership items (and the applicability of any penalties, additions to tax, or additional amounts) under the settlement, the final partnership administrative adjustment, or the decision of the court (whichever is appropriate) that gave rise to the liability in question shall be conclusive.

* * * *

Federal Regulations
Effective for Pre-1990 Tax Years

Treas. Reg. §301.6621-2T. Questions and answers relating to the increased rate of interest on substantial underpayments attributable to certain tax motivated transactions (temporary).

The following questions and answers relate to the increased rate of interest on substantial underpayments attributable to certain tax motivated transactions as provided in section 6621(d) of the Internal Revenue Code of 1954, as added by section 144 of the Tax Reform Act of 1984 (Pub.L. 98-369, 98 Stat. 682):

* * * *

Q-5. How is the amount of a tax motivated underpayment determined?

A-5. Except as provided in A-6 of this section, the amount of a tax motivated underpayment is determined in the following manner:

(1) Calculate the amount of the tax liability for the taxable year as if all items of income, gain, loss, deduction, or credit, had been reported properly on the income tax return of the taxpayer ("total tax liability"); and

(2) Without taking into account any adjustments to items of income, gain, loss, deduction, or credit that are attributable to tax motivated transactions (as defined in A-2 through A-4 of this section), calculate the amount of the tax liability for the taxable year as if all other items of income, gain, loss, deduction, or credit

had been reported properly on the income tax return of the taxpayer ("tax liability without regard to tax motivated transactions").

(3) The difference between the total tax liability and the tax liability without regard to tax motivated transactions is the amount of the tax motivated underpayment.

Example. Taxpayer A, a calendar year taxpayer, files his 1984 income tax return reporting $70,000 of taxable income and $23,171 of tax liability. On January 20, 1986, A enters into a closing agreement with the Internal Revenue Service that includes the following adjustments:

Section 162 deduction disallowed (not tax motivated)	$ 7,500
Loss disallowed under section 465 (tax motivated--see A-2(2) of this section)	$ 5,000
Section 170 deduction disallowed because of a valuation overstatement (tax motivated--see A-2(1) of this section	$10,000
Loss disallowed with respect to a straddle as defined in section 1092 (c) (tax motivated--see A-2(4) of this section	$ 7,000
Other adjustments (none of which are tax motivated)	$ 4,000

The tax motivated underpayment is determined in the following manner:

1.	$ 70,000	reported taxable income
	+ 33,500	(Add all adjustments to items of income, gain, loss, deduction, or credit (including tax motivated transactions subject to section 6621(d)))
	$103,500	Tax = $39,685 ("total tax liability")
2.	$ 70,000	reported taxable income
	+ 11,500	(Add adjustments to items of income, gain, loss, deduction, or credit other than those with respect to items that are tax motivated)
	$ 81,500	tax = $28,691 ("tax liability without regard to tax motivated transactions")

The tax motivated underpayment (*i.e.*, the underpayment attributable to tax motivated transactions) is $10,994 ($39,685–$28,691). Accordingly, the interest on $10,994 would be computed at the 120 percent rate.

The remainder of the underpayment (*i.e.*, the underpayment not attributable to tax motivated transactions) is $5,520 ($28,691 (tax liability without regard to tax motivated items)–$23,171 (tax paid with return)). The interest on $5,520 would be computed at the adjusted rate.

AMICUS CURIAE BRIEF

RECORD
AND
BRIEFS

No. 12-562

Supreme Court, U.S.
FILED
JUN 5 - 2013
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In The

Supreme Court of the United States

UNITED STATES,

Petitioner,

v.

GARY WOODS, as Tax Matters
Partner of Tesoro Drive Partners, et al.

**On Writ Of Certiorari To The
United States Court Of Appeals
For The Fifth Circuit**

BRIEF OF *AMICUS CURIAE* PROFESSOR AMANDEEP S. GREWAL IN SUPPORT OF NEITHER PARTY

PROF. AMANDEEP S. GREWAL
Amicus Curiae and Counsel of Record
UNIVERSITY OF IOWA COLLEGE OF LAW
478 Boyd Law Building
Iowa City, IA 52242
(319) 849-8757
agrewal@iowa.uiowa.edu

COCKLE LEGAL BRIEFS (800) 225-6964
WWW.COCKLELEGALBRIEFS.COM

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INTEREST OF *AMICUS CURIAE*[1]

Amicus is a professor at the University of Iowa College of Law, who teaches and writes in the area of federal tax law. This institutional affiliation is provided for identification purposes only.

The issues presented in this case seemingly relate only to the interpretation of technical jurisdictional and penalty provisions found in the Internal Revenue Code. However, the resolution of the interpretive issues may require the Court to discuss the controversial economic substance doctrine, which the district court applied in this case and which led to the penalty at issue. The interest of *Amicus* relates to ensuring the coherent development of tax-related judicial doctrines, including the economic substance doctrine, about which *Amicus* has previously written. *See* Amandeep S. Grewal, *Economic Substance and the Supreme Court*, 116 Tax Notes 969 (2007), *available at* http://ssrn.com/abstract=1013388.

Although the Court has not been asked to review the district court's application of the economic substance doctrine, some discussion of the doctrine seems

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[1] Consistent with Supreme Court Rule 37.3(a), this brief is filed with the written consent of both parties. Also, consistent with Supreme Court Rule 37.6, *Amicus* hereby certifies that this brief was not authored in whole or in part by counsel for any party and that *Amicus* received no monetary contribution toward the preparation or submission of this brief other than the general financial support of the academic institution with which he is affiliated.

inevitable, given its close relation to both questions presented. *Amicus* therefore writes to aid the Court by describing the controversy regarding the doctrine. The phrase "economic substance doctrine" appears in more than 100 district and appellate court opinions but has never appeared in any opinion of this Court. See also, *e.g.*, Jasper L. Cummings, Jr., *The Economic Substance Doctrine as Penalty*, 138 Tax Notes 1465, 1474 (2013) ("The Supreme Court has never created or applied the economic substance doctrine."). Consequently, anything that the Court says here will receive close attention from the tax bar and government attorneys.

The tax law would undoubtedly benefit from Court guidance regarding the economic substance doctrine, but this case only indirectly touches on the doctrine and therefore presents a poor vehicle through which to provide guidance. *Amicus* thus urges the Court to expressly reserve its opinion on the broader economic substance issues implicated in this case, as discussed below. If the Court speaks about the economic substance doctrine but makes no reservation, its silence may be taken as a tacit endorsement of the district court's approach, which *Amicus* believes misconstrues the relevant Court precedents.

SUMMARY OF ARGUMENT

The judicially-created economic substance doctrine, which the district court applied in this case and which led to the penalty at issue here, has given rise to substantial confusion and controversy in the past two decades. According to the majority view, the economic substance doctrine allows a court to disregard "mere compliance with the code," *Estate of Stauffer* v. *Commissioner*, 403 F.2d 611, 621 (9th Cir. 1968), when determining whether a transaction qualifies for a tax deduction or other benefit. Under this "extrastatutory" approach to the doctrine, a court generally requires that a transaction exhibit objective economic substance and a subjective business purpose, even if no statute imposes those requirements.[2]

A small number of courts have taken a different approach and view the economic substance doctrine only as a tool to aid the construction of a statute. Under this "interstitial" approach, if a statute requires objective economic substance or a subjective business purpose, the court will demand the same of the transaction before it. But if the statute does not make those inquiries relevant, a transaction can

---

[2] The economic substance doctrine sometimes gets blended or confused with other doctrines and may go by other names, like the "sham-transaction doctrine." See, *e.g.*, *Winn-Dixie Stores, Inc.* v. *Commissioner*, 254 F.3d 1313, 1316 (11th Cir. 2001). As used here, the economic substance doctrine refers to the two-pronged test, with objective and subjective elements, used by the federal district and appellate courts in determining whether to disregard a transaction.

create tax benefits even if it lacks objective economic substance or a subjective business purpose. See, *e.g.*, *W. & K. Holding Corp.* v. *Commissioner*, 38 B.T.A. 830, at *839 (1938) (contribution to corporation falls within nonrecognition provision even though no business purpose present; *Gregory* v. *Helvering*, 293 U.S. 465 (1935), distinguished).

In the present case, the district court followed the majority view and treated the economic substance doctrine as an extrastatutory test. Thus, in its order granting the government's motion for judgment as a matter of law, the court did not analyze any statutory law, nor did it cite any provision of law, other than one relating to its jurisdiction. See Pet. App. 15a-22a. The district court decided the case by finding that the taxpayers' transactions failed the economic substance doctrine and held that the claimed tax deductions consequently could not be enjoyed. See Pet. App. 20a-21a.

Neither party has sought review of the district court's application of the economic substance doctrine, but because the doctrine relates to both questions presented, some discussion of it may be necessary. The first question essentially asks whether the gross valuation misstatement penalty "relates to" the determination that the partnership lacked economic substance (i.e., was a sham), such that the penalty can be considered in a partnership-level

proceeding under Section 6226(f).[3] The second question relates to whether a gross valuation misstatement penalty in fact applies when the partnership is disregarded under the economic substance doctrine and the partners' outside bases are reduced to zero.

In addressing these issues, the Court should take a cautious approach and expressly reserve on whether the district court's extrastatutory application of the doctrine comports with the relevant precedents. The tax law will be best served if the Court addresses the validity of the extrastatuory approach (which *Amicus* disagrees with) when the relevant issues are properly briefed and argued, and not in connection with this case. Also, although Congress partially codified the doctrine in 2010, the new statute raises many questions, and the Court could risk prematurely answering those questions if it discusses the doctrine here.

Additionally, the Court should expressly reserve on whether a taxpayer may face penalties for violating federal common law. It's somewhat strange to impose a civil penalty without any finding that a taxpayer has violated a positively enacted law, but that's exactly what happens when a court upholds a penalty related to violating the extrastatutory economic substance doctrine. It's even stranger to impose

---

[3] Except when otherwise noted, all section references are to the Internal Revenue Code of 1986 (the tax code), codified in Title 26 of the U.S. Code, as in effect during the taxable years at issue.

criminal sanctions in these circumstances, but that happens too, in criminal prosecutions involving the doctrine. Any due process concerns raised by the application of penalties for a violation of federal common law should be addressed when the issues are properly presented, and not now, when the parties seem focused on thorny questions of statutory interpretation.

ARGUMENT

I. THE COURT SHOULD EXPRESSLY RESERVE JUDGMENT ON WHETHER THE DISTRICT COURT PROPERLY APPLIED THE ECONOMIC SUBSTANCE DOCTRINE

Judicial doctrines seem to abound in the tax law. The substance over form doctrine, the step transaction doctrine, and the assignment of income doctrine, to name a few, appear in opinions issued by most courts, including this one.

Although those of us in the tax field frequently call them "common law" doctrines, that's not really an accurate description of their function. Federal common law, strictly speaking, refers only to "a rule of decision that amounts, not simply to an interpretation of a federal statute or a properly promulgated administrative rule, but, rather, to the judicial creation of a special federal rule of decision." *Atherton* v. *FDIC*, 519 U.S. 213, 218 (1997) (internal quotation marks omitted). Tax-related judicial doctrines,

however, do not create special rules of decision. Instead, courts generally use tax-related judicial doctrines to help determine the meaning of the authoritative statute at issue.[4]

The economic substance doctrine operates differently. Under the majority approach, apparently based on this Court's opinion in *Gregory* v. *Helvering*, 293 U.S. 465 (1935) (*Gregory*), when the economic substance doctrine applies, a court neither interprets statutory language nor believes itself constrained by it. Instead, the court will demand that a transaction exhibit objective economic substance and a subjective business purpose, regardless of whether any statute imposes those requirements. Consequently, courts may reach their decisions without citing any income

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[4] For example, under the substance over form doctrine, if a taxpayer called a particular transfer of money to his child a deductible salary (as opposed to a nondeductible gift), the taxpayer's characterization of the transfer would not control. Rather, to determine whether the transfer created a deduction under Section 162(a)(1) of the tax code, the court would look to substance, not form, and examine whether the transfer really was made for services rendered. After all, Section 162(a)(1) grants a deduction for actual salaries, not just any transfer labeled as such. Thus, the substance over form doctrine would be used to help the court determine whether the transfer fell within the statute, not to establish a new rule of decision. The step transaction doctrine and the assignment of income doctrine operate similarly. See, *e.g.*, *Commissioner* v. *Banks*, 543 U.S. 426, 433-34 (2005) (using assignment of income doctrine to aid construction of Section 61); *Commissioner* v. *Clark*, 489 U.S. 726, 737-38 (1989) (using step transaction doctrine to help determine the meaning of "exchange" under Section 356(a)).

tax statutes, like the district court did below. See Pet. App. 15a-22a. Under this extrastatutory approach, embraced by almost all district and appellate courts, the economic substance doctrine provides an independent rule of decision and reflects true federal common law. See also, *e.g.*, *Crispin* v. *Commissioner*, T.C. Memo. 2012-70, 2012 WL 858406, at *5 n.12 (March 14, 2012) (declining to consider statutory arguments because case was decided under the economic substance doctrine), aff'd, 708 F.3d 507, 514 n.15 (3d Cir. 2013) (making similar statement).

Under a minority view, economic substance principles apply only to the extent that the governing statute makes them relevant. Courts following this interstitial approach read *Gregory* as a case that involved statutory interpretation, and not a case that created federal common law. However, a judge advocating that approach will likely find himself or herself writing in dissent or facing a firm reversal. See, *e.g.*, *ACM P'ship* v. *Commissioner*, 157 F.3d 231, 265 (3d Cir. 1998) (McKee, J., dissenting); *Coltec Indus., Inc.* v. *United States*, 62 Fed. Cl. 716 (2004) (concluding that an extrastatutory economic substance doctrine violates the separation of powers), vacated and remanded, 454 F.3d 1340 (Fed. Cir. 2006). And even if one panel on a court applies the interstitial approach, a later panel might apply an extrastatutory approach. Compare *Horn* v. *Commissioner*, 968 F.2d 1229 (D.C. Cir. 1992), with *Saba P'ship* v. *Commissioner*, 273 F.3d 1135 (D.C. Cir. 2001).

Nonetheless, as *Amicus* has previously written, the interstitial approach, and not the extrastatutory approach, best comports with the relevant Court precedents.[5] The Court has never decided a tax case by turning a blind eye to the governing statutes, nor has the Court ever dismissed compliance with the law as a mere formality. Instead, consistent with the interstitial approach, the Court applies economic substance principles consistent with the governing statutes, not in contravention of them. See *Boulware* v. *United States*, 552 U.S. 421, 430-31 (2008) (acknowledging that in characterizing corporate distribution, "economic substance remains the right

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[5] See Amandeep S. Grewal, *Economic Substance and the Supreme Court*, 116 Tax Notes 969 (2007), *available at* http://ssrn.com/abstract=1013388. *Amicus* favors a particular view of the economic substance doctrine but recognizes that this case does not present the right vehicle for the Court to resolve the controversy relating to the doctrine. This brief is consequently submitted in support of neither party. Regarding the questions presented, *Amicus* expresses no opinion on whether the district court had jurisdiction to consider the gross valuation misstatement penalty (the first question). Also, although *Amicus* has due process concerns regarding the imposition of a penalty for a violation of the extrastatutory economic substance doctrine (relating to the second question), *Amicus* does not expect the parties to argue that issue, even putting aside any limitations on raising new arguments in front of this Court. Judging from the history of this case, the parties will approach the second question only by addressing whether the taxpayer's understatement of tax was "attributable to" a gross valuation misstatement, as required to impose the penalty at issue. See 26 U.S.C. § 6662(h)(1) (2000). *Amicus* expresses no opinion on the interpretation of "attributable to."

touchstone," but rejecting imposition of extra-statutory intent requirement onto Section 301); *Nebraska Dep't of Revenue* v. *Loewenstein*, 513 U.S. 123, 133-34 (1994) (dismissing taxpayer's reliance on the economic substance analysis in *Frank Lyon Co.* v. *United States,* 435 U.S. 561 (1978), because the statute in that case related to the ownership of property, whereas the statute at issue was concerned with other things); *Cottage Sav. Ass'n* v. *Commissioner*, 499 U.S. 554, 562 (1991) (rejecting government's argument that taxpayer must satisfy economic substance test for transaction to trigger a loss under Section 1001, because the statute "embodies a much less demanding and less complex test"); *Frank Lyon Co.* v. *United States,* 435 U.S. 561, 583-84 (1978) (examining economic substance principles consistent with ownership determinations required by Section 167(a)); *United States* v. *Consumer Life Ins. Co.*, 430 U.S. 725, 740-41 (1977) (focusing on statutory requirements in determining whether to respect a transaction, and rejecting government's economic substance arguments, which had no statutory basis); *Knetsch* v. *United States*, 364 U.S. 361 (1960) (examining transaction to see whether it created genuine indebtedness under Section 163); *Gregory*, 293 U.S. at 470 (focusing on "statutory provision in question" in determining whether transaction qualified for benefit under the statute).

In the present case, the Court does not need to determine whether the extrastatutory approach or the interstitial approach reflects the correct understanding

of its precedents. Although the taxpayers' complaint presented a separation of powers challenge to the extrastatutory economic substance doctrine, see J.A. 67, the Court's review at this stage relates only to jurisdictional and penalty issues. To the extent that the Court must discuss the economic substance doctrine, it should acknowledge that the district court applied an extrastatutory test but it should not endorse that approach. The Court should address the validity of the extrastatutory approach at another time, when the relevant issues are properly briefed and argued.

A short discussion of two cases will help illustrate the sharp conflict between the extrastatutory and interstitial approaches and the importance of reserving judgment on this issue. In the first case, the Third Circuit applies an extrastatutory test and declines to interpret statutes, deciding that the economic substance doctrine trumps anything that Congress might have said. In the second case, the D.C. Circuit explicitly rejects the extrastatutory approach of three sister circuits and applies an interstitial approach.

A. The Extrastatutory Approach

The Third Circuit's opinion in *In re CM Holdings, Inc.*, 301 F.3d 96 (3d Cir. 2002), reflects a typical application of the extrastatutory approach. In that case, the taxpayer engaged in a complicated transaction designed, in part, to generate interest deductions

under Section 163(a). But the government challenged those deductions, and the parties ended up in court.

After losing in the district court, the taxpayer appealed and argued that the tax code supported its claimed deductions. The taxpayer had paid interest, and although Section 264 limits the interest deduction in some circumstances, the taxpayer argued that none of the special limitations applied. The Third Circuit, however, dismissed the taxpayer's reliance on statutes:

> We can forgo examining the intersection of these statutory details, for pursuant to *Gregory v. Helvering*, 293 U.S. 465 (1935), and *Knetsch v. United States*, 364 U.S. 361 (1960), courts have looked beyond taxpayers' formal compliance with the Code and analyzed the fundamental substance of transactions. Economic substance . . . is the Government's trump card; even if a transaction complies precisely with all requirements for obtaining a deduction, if it lacks economic substance it simply is not recognized for federal taxation purposes, for better or for worse.

In re CM Holdings, Inc., 301 F.3d 96, 102 (3d Cir. 2002) (parallel citations and internal quotation marks omitted). Having re-framed the inquiry as one of common law analysis and not of statutory interpretation, the court applied the economic substance doctrine and disallowed the taxpayer's claimed deductions.

The Third Circuit's approach reflects the majority view today. In numerous cases, courts will not interpret any income tax statute, but will instead decide a case entirely under the economic substance doctrine. See, *e.g.*, *Bank of N.Y. Mellon Corp.* v. *Commissioner*, 140 T.C. No. 2 (2013) (determining eligibility for foreign tax credit by reference to economic substance doctrine, not by reference to Section 901 and regulatory requirements). Alternatively, a court might consider statutory issues in one proceeding and economic substance issues in another. See *Klamath Strategic Inv. Fund, LLC* v. *United States*, 440 F. Supp. 2d 608 (E.D. Tex. 2006) (taxpayer wins statutory issue), and 472 F. Supp. 2d 885 (E.D. Tex. 2007) (but loses under the economic substance doctrine), aff'd, 568 F.3d 537 (5th Cir. 2009). Or, in a single opinion, a court may perform extensive statutory analysis and find that a taxpayer has complied with all relevant statutes, but then separately conclude that the taxpayer loses under the common law. See, *e.g.*, *Coltec Indus., Inc.* v. *United States*, 454 F.3d 1340 (Fed. Cir. 2006). In so doing, the courts may acknowledge that the economic substance doctrine is "disturbing" because it grants "unelected bureaucrats . . . the power to rewrite laws enacted by Congress and the President." *Jacobs Eng'g Grp., Inc.* v. *United States*, No. CV 96-2662, 1997 WL 314167, at *2 n.5 (C.D. Cal. Mar. 5, 1997). Nonetheless, the economic substance doctrine frequently denies taxpayers benefits, even when they have "complied with each and every of the relevant requirements imposed by

the Code." *H.J. Heinz Co.* v. *United States*, 76 Fed. Cl. 570, 592 (2007).

B. The Interstitial Approach

A court that applies an interstitial approach looks to the governing statute to determine whether and to what extent to apply economic substance principles. At times, this analysis will lead to the same result as under the extrastatutory approach – a transaction can easily fail both the economic substance doctrine and statutory requirements. But at other times, an interstitial approach will lead to a result different from that reached under an extrastatutory approach.

The circuit split created by the D.C. Circuit in *Horn* v. *Commissioner*, 968 F.2d 1229 (D.C. Cir. 1992) (*Horn*), nicely illustrates this. *Horn* involved retroactive congressional enactments related to some so-called straddle transactions, the exact details of which can be omitted here. It suffices to say that these complicated transactions were designed to produce tax losses, not to serve any legitimate business or profit-oriented purpose.

In the 1970's, the use of the straddle transactions became widespread, and the IRS undertook massive enforcement efforts. Congress then stepped in and enacted retroactive rules relating to straddles to help deal with the resulting judicial logjam. See *Glass* v. *Commissioner*, 87 T.C. 1087 (1986) (consolidated case

involving approximately 1,400 taxpayers) (subsequent history omitted).

Under Section 108(a) of the Deficit Reduction Act of 1984, Pub. L. No. 98-369, 98 Stat. 630, as amended by the Tax Reform Act of 1986, Pub. L. No. 99-514, § 1808(d), 100 Stat. 2817-18, Congress stated that a loss from a pre-1982 straddle transaction would be allowed only "if such loss is incurred in a trade or business, or if such loss is incurred in a transaction entered into for profit though not connected with a trade or business." This statute effectively denied taxpayers losses if they had entered into straddle transactions for purely tax avoidance purposes. However, in Section 108(b) of that statute, as amended, Congress established a special rule for commodities dealers. See Tax Reform Act of 1986, Pub. L. No. 99-514, § 1808(d), 100 Stat. 2817-18. Under Section 108(b), Congress said that "any loss incurred by a commodities dealer in the trading of commodities shall be treated as a loss incurred in a trade or business."

Various commodities dealers consequently argued that they could enjoy losses regarding their straddle transactions. See *Fox* v. *Commissioner*, T.C. Memo. 1988-570, 1988 WL 133254 (Dec. 15, 1988) (consolidated case involving multiple commodities dealers) (subsequent history omitted). After all, in Section 108(a), Congress said that straddle losses could be enjoyed if they were incurred in a trade or business, and in Section 108(b), Congress created an irrebuttable presumption that losses claimed by

commodities dealers were so incurred. Thus, the dealers argued, they should be able to enjoy deductions even if they were motivated solely by tax incentives.

Several circuit courts nonetheless concluded that the economic substance doctrine trumped the statute. Regardless of what any statute said, "[i]f a transaction is devoid of economic substance – as the transactions involved here undeniably were –, it simply is not recognized for federal taxation purposes, for better or for worse." *Lerman* v. *Commissioner*, 939 F.2d 44, 45 (3d Cir. 1991) (*Lerman*); accord *Gardner* v. *Commissioner*, 954 F.2d 836 (2d Cir. 1992); *Cook* v. *Commissioner*, 941 F.2d 734 (9th Cir. 1991). And if a transaction is "not recognized for tax purposes, section 108 does not even come into play." *Lerman*, 939 F.2d at 52. Thus, the dealers could not rely on the statute and their claimed losses were denied.

But the D.C. Circuit applied an interstitial approach and reached a different result. In that court's view, Section 108(b) plainly granted the dealers their claimed deductions. The court was "at a loss to understand the Commissioner's suggestion, adopted by several courts, that the [economic substance] doctrine applies independently of section 108." *Horn*, 968 F.2d at 1238. By refusing to even consider Section 108(b), the IRS and three circuit courts had "close[d] off any consideration of whether Congress intended the 'loophole'" offered by the statute and thereby "read it completely out of existence." *Id.* at 1234-38. Congress clearly granted deductions to commodities

dealers to help address the judicial logjam caused by straddle transactions – it was "inconceivable that Congress intended that the [economic substance] doctrine be laid *over* the statute." *Id.* at 1238. Although the D.C. Circuit reached its holding "with some trepidation in light of the contrary conclusions reached by three sister circuits," *id.* at 1234, the court would not allow the economic substance doctrine to "trump the plainly expressed intent of the legislature." *Id.* at 1231.

The circuit split regarding Section 108 of the Deficit Reduction Act nicely illustrates the differences between the extrastatutory and interstitial approaches to economic substance issues. Under the extrastatutory approach, Congress lacks the power to grant tax benefits to sham transactions (that is, transactions without economic substance). Consequently, a court simply will not look at a statute unless common law requirements are satisfied. See, *e.g.*, *Krumhorn* v. *Commissioner*, 103 T.C. 29, at *50 (1994) ("We disagree with the holding in *Horn* and hold, consistent with our prior cases and all other circuit courts . . . that it is appropriate before applying the per se rule of section 108(b) to inquire whether the straddle transactions at issue are devoid of economic substance."). But under the interstitial approach, although a court recognizes that it should think twice before blessing a tax-motivated transaction, it also recognizes that "[b]arring constitutional infirmity, Congress undoubtedly has the power to grant beneficial tax treatment to economically meaningless behavior." *Horn*, 968 F.2d at 1234. And even if

a transaction unquestionably lacks economic substance, the court must examine the relevant statute "to see whether it *nonetheless* authorizes the claimed deductions." *Id.* at 1238.

In the present case, the Court should expressly reserve on whether the extrastatutory or interstitial approach best comports with its precedents. Although support among the lower courts for the interstitial approach seems slim, that approach reflects the best reading of *Gregory* and recognizes Congress's plenary authority to establish the tax laws.

II. THE EXTRASTATUTORY VERSUS INTERSTITIAL ISSUE REMAINS IMPORTANT EVEN AFTER THE ECONOMIC SUBSTANCE DOCTRINE'S PARTIAL CODIFICATION

Although Congress partially codified the economic substance doctrine in 2010, the new statute does not explain *when* the doctrine applies.[6] And because

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[6] The new statute, 26 U.S.C. § 7701(o)(1) (Supp. V 2011), clears a circuit split regarding the formulation of the doctrine. Compare *Black & Decker Corp.* v. *United States*, 436 F.3d 431, 441 (4th Cir. 2006) (embracing a disjunctive test, under which a transaction must be respected if it exhibits either objective economic substance or a subjective business purpose), with *Coltec Indus., Inc.* v. *United States*, 454 F.3d 1340, 1355 n.14 (Fed. Cir. 2006) (explicitly rejecting Fourth Circuit's approach in favor of a conjunctive test). Section 7701(o)(1) adopts the conjunctive approach and says that the doctrine will be satisfied only if, to loosely paraphrase the statute, a transaction exhibits

the debate over the extrastatutory versus interstitial approaches largely turns on that issue, the new statute does not resolve the conflict between the approaches.

Section 7701(o)(1) indicates that the economic substance doctrine applies whenever it is "relevant." 26 U.S.C. § 7701(o)(1) (Supp. V 2011). However, relevancy is left entirely to the courts – "whether the economic substance doctrine is relevant to a transaction shall be made in the same manner as if this subsection had never been enacted." 26 U.S.C. § 7701(o)(5)(C) (Supp. V 2011). Under this statute, courts enjoy complete authority to determine the relevancy of the economic substance doctrine but cannot look to the statute for guidance (that is, they must pretend like it doesn't exist).

The relevancy of the economic substance doctrine will be determined differently under the extrastatutory and interstitial approaches. Under the extrastatutory approach, "economic substance is a *prerequisite* to the application of any Code provisions allowing deductions." *Lerman*, 939 F.2d at 52. Consequently, but for a narrow situation carved out by statute, see Section 7701(o)(5)(B), the extrastatutory approach calls for an economic substance inquiry in all cases. Under the interstitial approach, however, Section 7701(o)(1) will apply only when the relevant

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both objective economic substance and a subjective business purpose.

income tax statute provides some indication that Congress intended to incorporate economic substance principles.

The extrastatutory versus interstitial question thus remains important in future cases. If the Court finds that it must discuss the economic substance doctrine in this case, it should act cautiously and reserve on whether the district court properly applied the doctrine. In time, the Court will be asked to provide guidance on the Section 7701(o)(1) relevancy rule, and the Court may risk addressing that issue prematurely if it approves or disapproves of the district court's approach here.

III. THE COURT SHOULD EXPRESSLY RESERVE JUDGMENT ON WHETHER A TAXPAYER MAY FACE CIVIL OR CRIMINAL PENALTIES FOR VIOLATING FEDERAL COMMON LAW

The Court's analysis of the penalty issue, if it reaches it, will involve thorny questions of statutory interpretation and the handling of mathematical impossibilities. The parties will likely argue over the meaning of the statutory phrase "attributable to" and might debate whether the Treasury's expansion of the statute enjoys deference.[7] See 26 U.S.C. § 6662(h)(1)

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[7] Assuming other requirements are met, the gross valuation misstatement penalty, as in effect during the taxable year at issue, applies when the adjusted basis of property is 400 percent

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or more of the property's true basis. See 26 U.S.C. §§ 6662(b)(3), (e)(1)(A) & (h) (2000). However, in a case like this, where the IRS argues that a taxpayer has a zero basis in property, the statute does not apply. If a taxpayer claims a positive basis in property, but the property's basis is really zero, then the percent by which the claimed basis exceeds the true basis is considered undefined. And "undefined" is not equal to 400 percent or more, nor is it infinite – it's simply undefined. See Free Math Help, *Division By Zero*, http://www.freemathhelp.com/division-by-zero.html (last visited May 31, 2013); Professor Peter Alfeld, *Why can't we divide by zero?*, http://www.math.utah.edu/~pa/math/0by0.html (last visited May 31, 2013). A Treasury regulation addresses this by stating that zero basis circumstances are treated as satisfying the 400 percent or more threshold. See 26 C.F.R. § 1.6662-5(g). But this regulation, as a mathematical matter, misinterprets the statute and also contradicts its plain meaning – the statutory phrase "400 percent or more" does not include things that are undefined. (How can something be defined as "400 percent or more" if it cannot be defined?) *Amicus* thus believes that the regulation is invalid. Although the Treasury enjoys the authority to define ambiguous statutory language, it does not enjoy the power to define an unambiguously undefined mathematical concept. Nonetheless, *Amicus* is not aware of any circumstances where a taxpayer presented an argument along the lines suggested, and the lower courts generally apply a purposive approach to the valuation misstatement penalty and bless its application in zero basis circumstances. See, *e.g.*, *Gilman* v. *Commissioner*, 933 F.2d 143, 151 (2d Cir. 1991) (acknowledging that its holding "strains the natural reading of the statut[e]" and that it is "somewhat odd" to apply a percentage-based penalty when the property's true basis is zero, but finding that the penalty is warranted because it "surely reinforces the Congressional objective of lessening tax shelter abuse"). And it's not clear whether the taxpayers in this case ever made or preserved the argument suggested here, so the Court may be able to avoid philosophical questions related to division by zero. See *also* Charles Seife, *Zero: The Biography of a Dangerous Idea* 23 (2000) ("[D]ividing by zero destroys the entire framework of mathematics.").

(2000). As best as *Amicus* can tell, arguments in this case will not address whether, as a threshold matter, it's appropriate to penalize a taxpayer for failing the extrastatutory economic substance doctrine.

The Court has never spoken on the role of civil and criminal penalties in economic substance cases, and it should not broadly approve or disapprove of such penalties here. Determining whether penalties should apply for a failure to satisfy the common law involves difficult issues, which should be analyzed in the proper case. If the parties' arguments in this case relate only to matters of statutory interpretation and mathematical impossibilities, the Court's opinion should be similarly limited. Specifically, the Court should reserve on whether it's appropriate to penalize "mere formal compliance with statutory provisions." *Santa Monica Pictures, LLC* v. *Commissioner*, T.C. Memo. 2005-104, 2005 WL 1111792, at *99 (May 11, 2005) (rejecting reliance on statutory law as defense to Section 6662(b)(1) negligence penalty).

That's not to say that the taxpayers in this case complied with all relevant statutory provisions. If the district court had analyzed the taxpayers' transaction under the tax code, it could easily have found that it failed statutory requirements. The taxpayers' COBRA transaction reflected a dubious attempt to generate

tax losses, whether analyzed under statutory law or the common law.[8]

However, as numerous other cases show, it's perfectly possible to comply with all laws enacted by Congress but nonetheless fail the extrastatutory economic substance doctrine. See, *e.g.*, *Coltec Indus., Inc.* v. *United States*, 454 F.3d 1340 (Fed. Cir. 2006) (extensive statutory analysis showed that taxpayer had complied with the tax code, but transaction disregarded under economic substance doctrine);

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[8] See generally Karen C. Burke & Grayson M. P. McCouch, *COBRA Strikes Back: Anatomy of a Tax Shelter*, 62 Tax Law. 59, 72-78 (2008) (noting potential challenge to COBRA transaction under Section 752, which addresses tax consequences associated with a partner or partnership's assumption of a liability). Additionally, the taxpayers' transaction hinged on a finding that they created valid partnerships. But it's highly doubtful that an entity formed solely to generate tax losses qualifies as a partnership, as that term is used throughout Sections 701-777 of the tax code. See *Commissioner* v. *Culbertson*, 337 U.S. 733, 741-42 (1949) (partnership existence under the tax code turns on "whether the partners really and truly intended to join together for the purpose of carrying on the business and sharing in the profits and losses or both," and presumably not for the purpose of avoiding taxes) (citations and internal quotation marks omitted). Unfortunately, the district court did not analyze Section 752 or make a statutory determination regarding the existence of a partnership. Had it done so, the knotty economic substance issues discussed here may have been easily avoided. The record reflects only a general determination that the taxpayers' various transactions employing partnerships, S corporations, and limited liability companies must be ignored under the extrastatutory economic substance doctrine. See Pet. App. 20a-21a.

Horn, *supra*; *WFC Holdings Corp.* v. *United States*, Civil No. 07-3320, 2011 WL 4583817, at *32 (D. Minn. Sept. 30, 2011) (taxpayer complied with requirements of the tax code, but no refund unless transaction "passes muster under the common law"). When a taxpayer fully complies with all positively enacted law, a penalty should not even be on the table. In fact, due process concerns may arise when a taxpayer complies with all statutory law but faces a penalty after a judicial determination that his transaction violated a common law doctrine. Cf. *BMW of N. Am., Inc.* v. *Gore*, 517 U.S. 559, 574 n.22 (1996) (due process protections against "'judgments without notice'" apply to civil penalties) (citation omitted).

Due process concerns become especially pronounced in the criminal context, where the economic substance doctrine can lead to the imprisonment of a taxpayer, even if he has fully complied with a statute. In *United States* v. *Wexler*, 31 F.3d 117 (3d Cir. 1994) (*Wexler*), for example, the government charged the defendant with criminal tax fraud related to his involvement with complex repo-to-maturity transactions, which were designed to generate massive interest deductions. Before trial, the defendant proposed a jury charge based on Section 163(a) of the tax code, which allows deductions on "all interest paid or accrued within the taxable year on indebtedness." Under the proposed charge, the defendant would be saved from conviction if his transactions created genuine indebtedness, as required by the statute, regardless of whether they also satisfied the economic

substance doctrine. The district court, over the government's objection, accepted the defendant's proposed instruction.

Before the trial could begin, the government petitioned the Third Circuit for a writ of mandamus. It argued that a transaction that fails the economic substance doctrine cannot generate lawful interest deductions even if it "involve[s] the payment of interest on genuine indebtedness." *Wexler*, 31 F.3d at 122 (internal quotation marks omitted). Thus, according to the government, the jury instructions should allow for a conviction even if the defendant's transactions satisfied Section 163(a)'s requirements.

The Third Circuit agreed, emphasizing that "economic substance is a *prerequisite* to any Code provisions allowing deductions," *id.* at 124 (internal quotation marks and alterations omitted), and that the court's embrace of the doctrine "continues in full force today, with no exception for § 163 deductions." *Id.* at 127. The district court thus had to revise its jury instructions to allow for a conviction even if Section 163(a)'s specific requirements had been met, because the economic substance doctrine "*also* bars interest deductions under that section of the code." *Id.* at 123 (emphasis supplied).

The decision to extend the economic substance doctrine to criminal prosecutions should be made by the Supreme Court, not by the lower courts. Even if the Court endorses the majority view – that *Gregory* created true common law and did not follow statutory

law – none of the Court's cases say anything about prosecuting taxpayers for violating judge-made rules. Due process may require that the government point to statutory law, and not the common law, when building a criminal case against a defendant. See *United States* v. *Kozminski*, 487 U.S. 931, 951 (1988) (refusing "to tolerate the arbitrariness and unfairness of a legal system in which the judges would develop the standards for imposing criminal punishment on a case-by-case basis").

Recently, Congress codified a civil penalty for violating the economic substance doctrine, but the new statute exacerbates rather than mitigates the potential due process problems. Section 6662(b)(6) of the tax code imposes a 20% penalty on any underpayment attributable to a failure to satisfy the economic substance doctrine or a "similar rule of law" (an undefined phrase). 26 U.S.C. § 6662(b)(6) (Supp. V 2011). That penalty increases to 40% if the taxpayer didn't make proper disclosures on his return. See 26 U.S.C. § 6662(i) (Supp. V 2011). Although a taxpayer can usually escape the various Section 6662 penalties if he had reasonable cause for his underpayment and acted in good faith, no such defense exists for the Section 6662(b)(6) economic substance penalty. See 26 U.S.C. § 6664(c)(2) (Supp. V 2011). In other words, a taxpayer faces a strict liability penalty for violating the economic substance doctrine or a similar rule of law.

Recall, however, that Congress in Section 7701(o) explicitly declined to provide any guidance on when

the economic substance doctrine applies. Instead, courts must determine when the doctrine is relevant. Additionally, Section 7701(o)(5)(C) forbids courts (and therefore taxpayers) from looking at the statute for guidance on the relevancy question. The interplay between Section 7701(o) and the penalty provisions thus reveals a troubling set of circumstances:

> (1) Congress partially codified a doctrine;
>
> (2) Congress declined to provide guidance on when the doctrine applies;
>
> (3) Congress prevented courts and taxpayers from looking at the statute to determine when the doctrine applies;
>
> (4) But a failure to satisfy the doctrine, or an undefined similar rule of law, results in a strict liability penalty.

Amicus is not aware of any circumstance where Congress imposed a strict liability penalty but declined to explain when it might apply.

In coming years, the courts may be asked to determine the extent to which Congress can impose penalties in this manner. However, if the Court approves of penalties in this case, that might close off judicial consideration of the issue. After all, if penalties are appropriate here – when the district court pointed to no statute that the taxpayer violated and when there was no statute that even recognized the economic substance doctrine – then maybe the codified penalty poses no problems, either.

The Court should address how penalties relate to the economic substance doctrine when the parties brief and argue the relevant issues. If in this case the parties do not do so, but instead focus on issues of statutory interpretation and mathematical impossibilities, the Court should expressly reserve on whether, as a threshold matter, it is appropriate to penalize a taxpayer for violating the extrastatutory economic substance doctrine.

CONCLUSION

Because the economic substance doctrine relates to both questions presented, the Court may need to discuss the doctrine to some extent. If the Court discusses the doctrine, it should expressly reserve on whether the district court properly applied the doctrine. If the Court speaks about the economic substance doctrine but makes no reservation, its silence may be taken as a tacit endorsement of the extrastatutory approach. Although the Court may ultimately decide that *Gregory* authorizes judicial legislation, that decision should be made only after the relevant issues are briefed and argued, and not now.

Additionally, the Court should not express an opinion on whether it is appropriate to penalize a taxpayer for failing the economic substance doctrine. Although this case involves such a failure, the arguments here will probably relate only to hypertechnical interpretive and mathematical issues. Thus,

in deciding this case, the Court should expressly reserve on whether the doctrine can apply in the criminal context, and it should state that no inferences should be drawn about the constitutionality of the Section 6662(b)(6) civil penalty.

Respectfully submitted,

PROF. AMANDEEP S. GREWAL
Amicus Curiae and Counsel of Record
UNIVERSITY OF IOWA COLLEGE OF LAW
478 Boyd Law Building
Iowa City, IA 52246
(319) 849-8757
agrewal@iowa.uiowa.edu

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AMICUS CURIAE BRIEF

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AND
BRIEFS

No. 12-562

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IN THE

Supreme Court of the United States

UNITED STATES OF AMERICA, *Petitioner,*

v.

GARY WOODS, AS TAX MATTERS PARTNER OF TESORO DRIVE PARTNERS, ET AL., *Respondent.*

On Writ of Certiorari to the United States Court of Appeals for the Fifth Circuit

BRIEF OF NEW MILLENNIUM TRADING, LLC, AHG INVESTMENTS, LLC, NPR INVESTMENTS, LLC, ALPHA I, L.P., AND WEST VENTURES, L.P. AS *AMICI CURIAE*

in Support of Respondent and Affirmation of the United States Court of Appeals for the Fifth Circuit Opinion in No. 11-50487

THOMAS A. CULLINAN
Counsel of Record
N. JEROLD COHEN
SUTHERLAND ASBILL & BRENNAN LLP
999 Peachtree Street, NE
Atlanta, Georgia 30309
(404) 853-8000
tom.cullinan@sutherland.com

Counsel for Amici Curiae

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IN THE

Supreme Court of the United States

UNITED STATES OF AMERICA, *Petitioner,*

v.

GARY WOODS, AS TAX MATTERS PARTNER OF TESORO DRIVE PARTNERS, ET AL., *Respondent.*

On Writ of Certiorari to the United States Court of Appeals for the Fifth Circuit

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BRIEF OF NEW MILLENNIUM TRADING, LLC, AHG INVESTMENTS, LLC, NPR INVESTMENTS, LLC, ALPHA I, L.P., AND WEST VENTURES, L.P. AS *AMICI CURIAE*

in Support of Respondent and Affirmation of the United States Court of Appeals for the Fifth Circuit Opinion in No. 11-50487

INTEREST OF THE *AMICI CURIAE*

Amici are petitioning or intervening partners in five separate partnership proceedings pending in various courts, all of which involve the question originally presented in the United States' petition for a writ of certiorari, and one of which involves the jurisdictional question on which this Court ordered briefing.[1] Amici are filing this brief on behalf of each

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[1] Pursuant to Rule 37.6, *amici* state that no counsel for a party authored this brief in whole or in part, and no person or

of the respective partnerships in which they are a partner. Amici's interest is in the proper resolution of both questions. Amici have authority to file this brief pursuant to Rule 37.3.[2] A brief description of each amicus curiae follows:

Andrew J. Filipowski, through a grantor trust, is the sole member of AJF-1, LLC, which is the petitioning partner in *New Millennium Trading, LLC v. Commissioner*, United States Tax Court, docket number 3439-06. The *New Millennium* case raises an issue virtually identical to the jurisdictional issue that the Court has raised in this case: whether the Tax Court has jurisdiction in a partnership proceeding to determine penalties that are predicated on the basis that one partner claimed in assets that the partnership distributed to him.

Alan Ginsburg is a partner in AHG Investments, LLC and the petitioner in *AHG Investments, LLC v. Commissioner*, United States Tax Court, docket number 3745-09. *AHG* involves the proper application of the valuation misstatement penalty.

Harold Nix is a partner in NPR Investments, LLC. and an intervenor-plaintiff in *NPR Investments, LLC v. United States*, a refund appeal pending in the United States Court of Appeals for the Fifth Circuit, docket number 10-41219. *NPR* involves the proper application of the valuation misstatement penalty.

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entity, other than Amici and their counsel, made a monetary contribution to the preparation or submission of the brief.

[2] As reflected in letters filed with the Clerk, petitioner and respondent have consented to the filing of this brief.

Robert Sands is a notice partner in Alpha I, L.P. and has petitioned this Court for a writ of certiorari to the United States Court of Appeals for the Federal Circuit in docket numbers 2011-5024 and 2011-5030. *See Alpha I, L.P. v. United States*, 682 F.3d 1009 (Fed. Cir. 2012), *petition for cert. filed*, (U.S. Nov. 1, 2012) (No. 12-550). The *Alpha I* case involves the proper application of the valuation misstatement penalty. Notably, the *Alpha I* case does not present the same jurisdictional issue that is present in this case, as the valuation misstatement penalty in that case was asserted based on the partnership's alleged overstated basis (i.e. "inside basis").[3]

Anthony T. Sleiman is a partner in West Ventures, L.P. and the petitioner in *West Ventures, L.P. v. Commissioner*, United States Tax Court, docket number 24683-10. *West Ventures* involves the proper application of the valuation misstatement penalty.

SUMMARY OF ARGUMENT

The district court lacked jurisdiction in the partnership proceeding to determine penalties predicated upon adjustments to outside basis. The Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA") provides for the determination of "partnership items" in the partnership proceeding, and "affected items" (such as a partner's outside basis) in subsequent partner level proceedings. *See*

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[3] The basis that a partner has in her partnership interest is often referred to as "outside basis." "Inside basis," on the other hand, refers to the basis that a partnership has in its own assets.

26 U.S.C. §§ 6221 and 6230; *see generally* Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248, § 402, 96 Stat. 324, 648-67 (codified as amended at 26 U.S.C. §§ 6221-6232). Under TEFRA, and specifically Section 6230,[4] the Internal Revenue Service (the "IRS") is required to follow deficiency procedures with respect to penalties that relate to adjustments to affected items that require partner level determinations, such as outside basis. The government's argument to the contrary rests on the nonsensical premise that a court in a TEFRA partnership proceeding, though it lacks jurisdiction to determine outside basis, nevertheless has jurisdiction to determine the applicability of penalties predicated on adjustments to outside basis.

Amici also support affirmation of the Fifth Circuit's determination below that no valuation misstatement penalty under Section 6662 may be imposed with respect to a claimed loss where the loss is disallowed for reasons unrelated to value. This determination is consistent with the IRS's longstanding interpretation of the statute, as first embodied in a litigation guideline memorandum from 1992, and as recently reaffirmed in a 2011 IRS Chief Counsel Notice.

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[4] All subsequent references to "Section" or "Code" are to the Internal Revenue Code of 1986, as amended and as it existed in 1999, unless otherwise indicated. References to regulations are to Treasury regulations as they existed in 1999.

ARGUMENT

I. The Trial Court Lacked Jurisdiction Under Section 6226(f) to Determine the Applicability of Valuation Misstatement Penalties Predicated on Adjustments to Outside Basis.

A. The Court Lacks Jurisdiction In This Case to Determine the S Corporations' Bases In the Sun Microsystems Stock and Canadian Currency Or Any Penalty That Is Predicated On An Adjustment to Their Bases.

TEFRA requires the tax treatment of any "partnership item" to be determined at the partnership level. *See* Section 6221. In most cases, after the partnership proceeding is over the IRS may directly assess the partners for any change in tax liability that is caused by an adjustment to a partnership item. *See* Section 6230(a)(1). Where, however, the change in tax liability cannot be determined without "partner level determinations," the IRS must apply the Code's deficiency procedures. *See* Section 6230(a)(2)(A)(i). Likewise, penalties that "relate[ ] to" an adjustment to a partnership item must be determined at the partnership level. *See* Section 6221. Where the penalty is based on an item that requires partner level determinations, however, the penalty must also be determined in that partner level proceeding. *See* Section 6230(a)(2)(A)(i). The trial court lacked jurisdiction over the penalties in this case because they are based on an item—the S corporations' sales of stock and foreign currency—that requires partner level determinations.

A "partnership item" is "any item required to be taken into account for the partnership's taxable year under any provision of subtitle A to the extent

regulations prescribed by the Secretary provide that, for purposes of this subtitle, such item is more appropriately determined at the partnership level than at the partner level." Section 6231(a)(3). The quintessential example of a "partnership item" is the "partnership aggregate and each partner's share of . . . [i]tems of income, gain, loss, deduction, or credit of the partnership." *See* Treas. Reg. § 301.6231(a)(3)-1(a)(1)(i).

Once the partnership proceeding is over, the IRS will make a "computational adjustment" to change the tax liability of a partner to properly reflect the treatment of a partnership item. *See* Section 6231(a)(6); Temp. Treas. Reg. § 301.6231(a)(6)-1T(a). "A computational adjustment includes a change in tax liability that reflects a change in an affected item where that change is necessary to properly reflect the treatment of a partnership item, or any penalty, addition to tax, or additional amount that relates to an adjustment to a partnership item." Temp. Treas. Reg. § 301.6231(a)(6)-1T(a).

An "affected item" is "any item to the extent such item is affected by a partnership item." Section 6231(a)(5). There are two types of affected items: those that require "partner level determinations," and those that do not. The IRS must follow the Code's deficiency procedures before assessing partners for any additional tax that requires a partner level determination, but can directly assess partners for the change in their tax liability that is attributable to an affected item that does not require a partner level determination. *See* Temp. Treas. Reg. § 301.6231(a)(6)-1T(a)(1), (2).

Section 6230 coordinates the TEFRA provisions with the Code's deficiency procedures. The general rule is stated in the first part of the statute: "Except as provided in paragraph (2) or (3), subchapter B of this chapter [i.e., the deficiency procedures] shall not apply to the assessment or collection of any computational adjustment." Section 6230(a)(1). Section 6230(a)(2)(A)(i), in turn, provides:

> Subchapter B shall apply to any deficiency attributable to affected items which require partner level determinations (other than penalties, additions to tax, and additional amounts that relate to adjustments to partnership items).

Thus, in order to collect additional tax that reflects a change in the type of affected item that requires a partner level determination, Subchapter B (which contains the Code's deficiency procedures) requires that the IRS first issue a notice of deficiency to the partner. *See* Section 6212. The partner may then contest the notice of deficiency in the Tax Court before paying any additional tax. *See* Section 6213.

The regulations under Section 6231 provide guidance on when a partner level determination is required. A change in a partner's tax liability that is related to "the threshold amount of medical deductions under section 213 that changes as the result of determinations made at the partnership level" is the type of affected item that may be directly assessed. *See* Temp. Treas. Reg. § 301.6231(a)(6)-1T(a)(1). On the other hand, a change in tax liability with respect to "a partner's at-risk amount to the extent it depends upon the source from which the partner obtained the funds that the partner

contributed to the partnership" is a computational adjustment subject to the Code's deficiency procedures. *See* Temp. Treas. Reg. § 301.6231(a)(6)-1T(a)(2).

In most cases, including this one, outside basis is an affected item. *See, e.g., University Heights v. Comm'r*, 97 T.C. 278 (1991); *Dial v. Comm'r*, 95 T.C. 1 (1990); *Gustin v. Comm'r*, 83 T.C.M. (CCH) 1341 (2002); *Allen Family Foods, Inc. v. Comm'r*, 80 T.C.M. (CCH) 562 (2000); (*see also* Gov't Br. 32). That is because a partnership is not usually required to take its partners' outside bases into account in preparing its own tax return and the Commissioner has not identified outside basis in the regulations as an item that is more appropriately determined at the partnership level (except in circumstances not at issue here). *See* Section 6231(a)(3) (defining "partnership item" as an item having those missing characteristics). Moreover, the determination of outside basis typically depends on facts that are unique to each partner, such as how much they paid for any property they acquired and then contributed to the partnership.

Outside basis is the type of affected item that requires partner level determinations. *See Napoliello v. Comm'r*, 655 F.3d 1060, 1062 (9th Cir. 2011); *Desmet v. Comm'r*, 581 F.3d 297, 303 (6th Cir. 2009). As such, Section 6230(a)(2)(A)(i) requires that any computational adjustment relating to outside basis be subject to the Code's deficiency procedures. *See Napoliello*, 655 F.3d at 1064 ("We hold that the IRS properly sent Napoliello an affected item notice of deficiency because the deficiency [arising from the IRS's recalculation of Napoliello's outside basis]

required a partner-level determination."); *Desmet*, 581 F.3d at 300-01.

In this case, the government recognizes that a determination of the S corporations' bases in the stock and currency that they sold depends on the outside bases that those S corporations had in the partnerships, which carried over to the stock and currency.[5] Amici disagree, however, with the government's repeated contention in this case that "each partner's correct outside basis in the partnerships was zero." (Gov't Br. 18; *see also* Gov't Br. 24-25, 26, 27, 32, 42.) To the contrary, each partner's correct outside basis is presently unknown, as it must be determined in subsequent partner level proceedings under the framework described above.

The S corporations' bases in the stock and foreign currency must be determined before any underpayment, or related penalty, can be determined. A court will have to determine "the portion of the stock [and currency] actually sold, the holding period for the stock [and currency], and the character of any gain or loss." *See Desmet*, 581 F.3d at 303 (quoting *Domulewicz v. Comm'r*, 129 T.C. 11 (2007)). The court will also have to determine the dollar amount of the basis. To use the government's

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[5] The IRS is seeking to impose penalties in this case based on the purported underpayments of tax that resulted from the S corporations purportedly claiming an "inflated" carryover basis in the Sun Microsystems stock and Canadian dollars that they sold. As the government says it, "[a]ny overstatement penalty assessed in this case will be assessed because the partners claimed a basis higher than zero in those assets." (Gov't Br. 32.)

hypothetical numbers from pages 15 and 16 of its brief, it appears that the basis in the distributed assets would be $8 million, reflecting the $3 million in cash and $5 million net premium paid for the option positions, adjusted by any gains or losses reported by the partnerships, less any other cash that the partnerships distributed to the partners. *See* Sections 705, 722 and 732(b). Or perhaps the partners should be treated as having directly acquired the stock and currency, giving them a $2 million basis, equal to what the partnerships paid for those assets. Or perhaps the government is correct that the S corporations' bases in the assets should be zero as a punitive consequence for having engaged in a transaction that lacks economic substance, notwithstanding that the partners effectively paid $8 million for the stock and currency. Regardless, that is not a determination that the trial court had jurisdiction to make in this case, as the S corporations' bases in the stock and currency is not a partnership item. It is an affected item that requires partner level determinations to be made in separate proceedings after this partnership proceeding is concluded.

In other cases like this one, the government has agreed that basis in distributed assets must be determined in partner level proceedings after the partnership proceeding is concluded, and that basis might be determined to be something other than zero. *See, e.g.*, Brief for the Appellant at 37, *Petaluma FX Partners, LLC v. Comm'r*, 109 A.F.T.R.2d 2012-2238 (D.C. Cir. 2012) (No. 11-1084), 2011 WL 3382390 ("The shamming of the partnership and the disallowance of the capital contributions will be taken into account in the

computational adjustment by either reducing to zero the bases the partners claimed in the Scient stock or by substituting Petaluma's basis in this stock for the bases the partners claimed on their returns."). The government's repeated claim in this case that basis is "zero" is apparently meant to suggest that the determination of outside basis and, apparently, the bases in the Sun Microsystems stock and Canadian currency is a *fait accompli*. That suggestion would be wrong, however, because the trial court in this partnership proceeding does not have jurisdiction to determine the S corporations' bases in the stock and currency and their bases may or may not be zero.

The trial court also did not have jurisdiction in this partnership proceeding to determine whether the valuation misstatement penalty applied because that penalty is directly predicted on assertions that the trial court lacks jurisdiction to determine (i.e., that the S corporations' bases in the stock and currency was zero). It would be "putting the cart before the horse" to find that the trial court *has* jurisdiction to determine a penalty that is predicated on a determination that the trial court *lacks* jurisdiction to make.

B. The Government's Position Would Require Three Different Proceedings to Determine Outside Basis and The Valuation Misstatement Penalty.

The government has argued that the trial court has jurisdiction in the partnership proceeding to abstractly determine the partners' outside bases solely for purposes of determining whether the penalties may apply. This Court has rejected the concept of "hypothetical jurisdiction." *Steel Co. v.*

Citizens for a Better Env't, 523 U.S. 83, 94 (1998) (citing *Ex parte McCardle*, 7 Wall. 506, 514 (1868)). Moreover, the government's position would directly undermine the efficiencies that Congress achieved in TEFRA, as it would require three different proceedings to finally determine the partners' bases (and the carryover bases that the S corporations claimed in the stock and currency) and any penalty that is predicated on an adjustment to their bases.

The procedure the government seeks to impose is first to reach a determination in the partnership case that the penalty is abstractly applicable. This would apparently be based on a tentative determination that the bases in the stock and currency sold by the S corporations was overstated by more than 400% which, in the government's view, is sufficient to cause the gross valuation misstatement penalty to apply. However, after the partnership proceeding is complete it would be necessary for the IRS to issue notices of deficiency to McComb and Woods to actually adjust the S corporations' bases in the stock and currency that they received from the partnerships. *See* Section 6230(a)(2)(A)(i); *Napoliello*, 655 F.3d at 1062; *Desmet*, 581 F.3d at 300-01. The partners could then contest those proposed adjustments in a second judicial proceeding. Under its proposed procedures, the IRS would not issue notices of deficiency to assess any penalties that were abstractly determined to be applicable; rather, the government claims that the IRS may directly assess those penalties, without following normal deficiency procedures. (*See* Gov't Br. 13, 23.) The partners then would have six months to pay the penalties and sue for refunds, starting a third judicial proceeding for each of them.

In that proceeding, the partners will presumably be entitled to challenge the first court's tentative computation of basis and raise any partner level reasonable cause defense to the penalties.

It is hard to believe that Congress envisioned that convoluted procedural framework when it enacted TEFRA or made changes to it in 1997.[6] Instead, as discussed next, TEFRA unambiguously requires that affected items requiring partner level determinations and penalties predicated thereon be determined in the same partner level deficiency proceeding.

C. The Government Must Follow Deficiency Procedures for Penalties that Require "Partner Level Determinations."

Prior to 1997, trial courts did not determine penalties in TEFRA cases. *See N.C.F. Energy Partners v. Comm'r*, 89 T.C. 741, 744-45 (1987), *superseded by statute*, Taxpayer Relief Act of 1997, Pub. L. No. 105-34, § 1238(a), 111 Stat. 788, 1026. Under the old scheme, trial courts considering a

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[6] The relationship between the three different proceedings raises a quagmire of issues. For example, how should the court's preliminary computation of basis and imposition of the penalty in the partnership case be reconciled with the final computation of basis and penalties in the partner level proceedings? How would the government collect additional penalties in the partner level proceedings if, as the government claims, penalties must be determined in the partnership proceeding? What would happen, for example, if the trial court in the partnership case abstractly determined outside basis to be overstated by less than the 400% that the government claims is necessary to impose the gross valuation misstatement penalty, but outside basis is finally determined at the partner level to be overstated by more than 400%?

TEFRA partnership case were limited to determining partnership items. If the trial court sustained the IRS's adjustments in any given case, the applicability of any penalty would then be determined in subsequent proceedings on a partner-by-partner basis (e.g., to determine whether a particular partner was negligent). *Id.*

Congress recognized that this system was inefficient:

> Many penalties are based upon the conduct of the taxpayer. With respect to partnerships, the relevant conduct often occurs at the partnership level. In addition, applying penalties at the partner level through the deficiency procedures following the conclusion of the unified proceeding at the partnership level increases the administrative burden on the IRS and can significantly increase the Tax Court's inventory.

H.R. REP. NO. 105-148 at 594 (1997), *reprinted in* 1997 U.S.C.C.A.N. 678, 988. Recognizing that the relevant conduct "often" occurs at the partnership level, Congress changed the law in 1997 so that now "the tax treatment of any partnership item (and the applicability of any penalty . . . which relates to an adjustment to a partnership item) shall be determined at the partnership level." *See* Section 6221 (emphasis added).

At the same time, Congress specifically extended the jurisdiction of courts to determine penalties in partnership cases by amending Section 6226(f) which states in its present form:

> A court with which a petition is filed in accordance with this section shall have

> jurisdiction to determine all partnership items of the partnership for the partnership taxable year to which the notice of final partnership administrative adjustment relates, the proper allocation of such items among the partners, and the applicability of any penalty . . . which relates to an adjustment to a partnership item.

Section 6226(f) (emphasis added). The determination at the partnership level of the applicability of any penalty that relates to an adjustment to a partnership item is conclusive, although a "partner shall be allowed to assert any partner level defenses that may apply." *See* Section 6230(c)(4).

Sections 6221 and 6226(f) in their present form provide courts with jurisdiction in the partnership proceeding to determine the applicability of any penalty "which relates to an adjustment to a partnership item." They do not provide the courts in a partnership case with jurisdiction over any penalty that relates to an adjustment to an affected item. Where the penalty relates to an adjustment to an affected item, the IRS must directly assess the penalty if no partner level determinations are required. *See* Section 6230(a)(1). Where, as here, the penalty relates to the type of affected item that requires a partner level determination, the IRS must follow the Code's deficiency procedures to collect the additional tax and related penalty. *See* Section 6230(a)(2)(A)(i).

Section 6230(a)(2)(A)(i) makes the deficiency procedures applicable to "affected items which require partner level determinations" but carves out a limited exception for penalties "that relate to adjustments to partnership items." *Id.* Congress'

qualification of the exception to only penalties "that relate to adjustments to partnership items" reflects Congress' understanding, as expressed in the legislative history, that "[w]ith respect to partnerships, the relevant conduct often occurs at the partnership level." H.R. REP. NO. 105-148 at 594 (1997). If the government were correct that Congress intended the applicability of all penalties to be determined in the partnership proceeding, Congress would not have put the clause "that relates to adjustments to partnership items" in Section 6230(a)(2)(A)(i). Indeed, that clause is meaningless under the government's interpretation, as Congress could have made the deficiency procedures inapplicable to all penalties by simply stating "other than penalties." "Often" does not mean "always." Read in context, Section 6230(a)(2)(A)(i) makes clear that when, as in this case, the conduct that could give rise to the penalty occurs at the partner level, the penalty must be determined at the partner level.

It is notable that the government does not contend that all facts necessary to impose the penalty must be determined at the partnership level. That is because the penalty that may be imposed on a particular partner cannot be computed until that partner's tax liability is determined, as the accuracy-related penalties are computed as a percentage of any underpayment. *See* Section 6662. As the government explains, some penalties do not apply until certain thresholds are met, and no accuracy-related penalty would apply if the partner did not underpay her income tax (e.g., because she had unrelated losses). (*See* Gov't Br. 13, 35.) The government contends that these determinations are not subject to Section 6230(a)(2)(A)(i) because,

according to the government, they are "partner level defenses" to be raised by partners in refund proceedings after payment of the asserted penalties. (*Id.*)

Thus, according to the government, all facts related to any penalty determination in a TEFRA case fall into one of two camps: 1) those pertaining to the applicability of a penalty that relates to an adjustment to a partnership item, that are appropriately determined in the partnership proceeding, and 2) those that relate to "partner level defenses," that are appropriately determined in partner level refund proceedings. (Govt. Br. 13); Treas. Reg. § 301.6221-1(d). The government apparently believes that it is never appropriate to determine any aspect of the penalty in deficiency proceedings.

The government's reading of TEFRA is flawed and leads to obviously unintended consequences. It is strained to call a threshold issue like "whether the taxpayer's individual return understated the tax owed by at least $5000," (Govt. Br. 13), a "defense" to the penalty. It is even more strained to call the question whether the partner has even underpaid her tax a "defense." (*See* Gov't Br. 35.) The flaw in the government's analysis is most apparent, however, when one considers its practical consequences. Consider the government's claim that whether a taxpayer has actually underpaid her taxes (e.g., because she has other legitimate losses) is a "partner level defense" that can only be asserted in a refund proceeding after the partner pays the penalty. (Gov't Br. 35.) If the IRS finds that the taxpayer has underpaid her taxes for reasons unrelated to the partnership, however, it will issue a notice of

deficiency, allowing the taxpayer to go to the Tax Court. *See* Section 6213. In that scenario, two different courts will be faced with the same issue: whether the taxpayer underpaid her taxes. It seems implausible that Congress would have intentionally crafted such a framework.

The proper and far more logical reading of TEFRA is that a penalty may not be determined at the partnership level if it relates to an adjustment to an affected item that requires partner level determinations within the meaning of Section 6230(a)(2)(A)(i).

The government's claim that requiring it to follow deficiency procedures for penalties that require partner level determinations would nullify the 1997 changes to TEFRA because "[p]enalties virtually always require further partner-level determinations," (Gov't Br. 11, 22), is greatly exaggerated. To the contrary, the 1997 changes make partner level determinations unnecessary with respect to most penalties. The change in a partner's tax liability that reflects an adjustment to a partnership item likewise could be said to "virtually always require partner-level determinations" yet, as the government explains, no partner level determination is required "in the case of a purely mathematical change to the partner's return." (Gov't Br. 10.) In most cases, therefore, the additional tax that results from an adjustment to a partnership item can be directly assessed because it is purely mathematical. Likewise, most penalties do not require partner level determinations because they are purely mathematical, as they are generally calculated as a percentage of the underpayment. *See* Section 6662.

For example, in the common situation where the IRS adjusts the income or loss reported by a partnership, the change in the partners' tax liability that results from the adjustment at the partnership level will almost always be purely mathematical. It would therefore usually be appropriate for the IRS to directly assess the change in the partners' tax liability that results from the adjustment to the partnership's income or loss. *See* Section 6230(a)(1); Temp. Treas. Reg. § 301.6231(a)(6)-1T(a)(1). If the IRS asserts that the partnership was negligent, the "applicability of that penalty" is properly determined at the partnership level because no partner level determinations need be made to establish the factual support for that penalty.[7]

Before the changes to TEFRA in 1997, the applicability of the negligence penalty was a partner level determination that was made after the partnership proceeding was concluded. *See, e.g., N.C.F. Energy Partners v. Comm'r*, 89 T.C. 741, 745 (1987). The partner level determinations that were required under prior law (i.e., whether each partner was negligent) are no longer required and the negligence penalty may be directly assessed (in this example) because it is purely mathematical. The 1997 changes therefore have had great effect.

The government's claim that "[p]enalties virtually always require further partner-level determinations" is also inconsistent with its (equally incorrect) claim that application of the penalty in this case "does not

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[7] The partner may assert partner level defenses, such as that he acted reasonably and in good faith, in a separate refund proceeding. *See* Section 6230(c)(4).

depend on factors specific to any individual partner." (Gov't Br. 23, 37.) The applicability of the penalty in this case most certainly depends on factors specific to an individual partner. As the government repeatedly explains, the penalty at issue in this case is directly predicated on the outside bases that carried over to the stock and currency that the partnerships distributed to the S corporations. (*See* Gov't Br. 18 ("the IRS concluded . . . that each partner's correct outside basis in the partnerships was zero. For that reason, the FPAAs determined that a 40% penalty for a gross misstatement of basis would apply . . . .").) The partners' outside bases was not reported on the partnership returns and is personal to each partner. Indeed, in many cases, including in some of the cases involving Amici, the IRS has asserted that only some, but not all, of the partners in those partnerships overstated their outside bases. To paraphrase the government, logically it makes perfect sense to determine whether the valuation misstatement penalty applies at the partner level because that penalty may apply against one partner (who overstated his basis) but not against another (who did not). (*See* Gov't Br. 31.)

Finally, the courts have repeatedly rejected the expansive view of jurisdiction that the government presses here in a closely analogous context. The jurisdictional statute Section 7422(h) provides that "[n]o action may be brought for a refund attributable to partnership items (as defined in section 6231(a)(3)) except as provided in section 6228(b) or section 6230(c)." The government has sought to define "attributable to" for purposes of Section 7422(h) as it seeks to have this Court now define "relates to" for purposes of Section 6221 and Section

6226(f). In both cases, the government's position is that the phrase should broadly be defined to include any item that is in any way connected to an adjustment to a partnership item. The courts have universally rejected that position for purposes of Section 7422(h) and there is no reason for the outcome to differ for purposes of Sections 6221 and 6226(f). The Second Circuit described the issue like this:

> At some level of generality, of course, most refund actions involving the taxation of a partnership can be described as seeking a refund "attributable to partnership items," I.R.C. § 7422(h). . . . But such a reading of the phrase "attributable to partnership items" would make most or all refund claims arising out of the taxation of partnerships, even those entirely about and entirely dependent on facts peculiar to a single partner, claims for refunds "attributable to partnership items."

Monti v. United States, 223 F.3d 76, 82 (2d Cir. 2000).

The courts have therefore repeatedly rejected the government's broad definition of "attributable to" in the Section 7422(h) context to preserve the dichotomy between partnership items and affected items. *See Prochorenko v. United States*, 243 F.3d 1359, 1363 (Fed. Cir. 2001) ("Construing the phrase 'attributable to partnership items' so broadly as to cover claims that depend on the unique circumstances of an individual partner, and that only affect that partner, would be contrary to the system of separate treatment of partnership items and nonpartnership items established by Congress in enacting TEFRA.");

Field v. United States, 328 F.3d 58, 59-60 (2d Cir. 2003) (determining that Section 6621(c) penalty interest is an affected item and a refund claim for such interest is not foreclosed); *Rigas v. United States*, 486 F. App'x 491, 500-01 (5th Cir. 2012) (narrowly defining phrase "attributable to partnership items" to exclude right to consistent settlement of partnership items); *Clark v. United States*, 68 F. Supp. 2d 1333, 1347-48 (N.D. Ga. 1999) (noting that Section 7422(h) did not bar jurisdiction over affected items such as penalties for negligence and valuation overstatement that require factual determinations at the partner level).

These courts recognized the well-settled principle in TEFRA that issues that are unique to certain partners are more appropriately determined in partner level proceedings. *See, e.g.*, *Prochorenko*, 243 F.3d at 1363; *Monti*, 223 F.3d at 82.

That same principle applies with equal force in this case, as the asserted penalties are dependent on facts unique to the individual partners—i.e., their purported overstatements of basis. It would be very peculiar for the court to determine a penalty in the partnership proceeding (and thus against all of its partners) that is based on the conduct of a single partner (i.e., because that partner overstated his outside basis).

The Court should follow the reasoning of the courts that have interpreted Section 7422(h) and hold that when the penalty is predicated on partner level conduct that requires partner level determinations within the meaning of Section 6230(a), the court in the partnership proceeding has no jurisdiction to determine the applicability of that penalty.

II. The Valuation Misstatement Penalties Do Not Apply To An Underpayment Of Tax Resulting From the Disallowance of A Loss For Reasons Unrelated to Value.[8]

The Internal Revenue Code imposes an accuracy-related penalty on certain underpayments of tax. *See* Section 6662. Included within these penalties are the penalties for "substantial valuation misstatements" and "gross valuation misstatements." Section 6662(e), (h). There is a 20% penalty on any underpayment of tax that is "attributable to" a "substantial valuation misstatement" and a 40% penalty on any underpayment of tax that is "attributable to" a "gross valuation misstatement." *Id.* A "substantial valuation misstatement" exists if "the value of any property (or the adjusted basis of any property) claimed on any return of tax imposed by chapter 1 is 200 percent or more of the amount determined to be the correct amount of such valuation or adjusted basis (as the case may be)." Section 6662(e). A "gross valuation misstatement"

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[8] A petition for writ of certiorari is pending in *Alpha I*. *See Alpha I, L.P. v. United States*, 682 F.3d 1009 (Fed. Cir. 2012), *petition for cert. filed*, (U.S. Nov. 1, 2012) (No. 12-550). That petition also raises the issue of the proper interpretation and application of the valuation misstatement penalties. Unlike in this case, however, there is no question about the jurisdiction of the courts to consider those issues, because the penalty in *Alpha I* is predicated on the "inside basis" that the partnership claimed on the sale of stock. If the Court determines that jurisdiction is lacking in this case, it should grant the petition that is pending *Alpha I* to allow it to decide the questions surrounding the valuation misstatement penalties.

exists if the value or basis is overstated by 400% or more. Section 6662(h).

The valuation misstatement penalty was enacted "to deal with various problems related to valuation of property." H.R. REP. NO. 97-201, at 243 (1981). The House Report explains:

> This particular need is illustrated by the fact that there are about 500,000 tax disputes outstanding which involve property valuation questions of more than routine significance. These cases alone involve approximately $2.5 billion in tax attributable to the valuation issues.
>
> The committee recognizes that valuation issues frequently involve difficult questions of fact. Often, these issues seem to be resolved simply by "dividing the difference" in the values asserted by the Internal Revenue Service and those claimed by the taxpayer. Because of this approach to valuation questions, the committee believes that taxpayers have been encouraged to overvalue certain types of property and to delay the resolution of valuation issues. Because the tax interest rate has been below the prevailing cost of borrowing, this tendency probably has been accentuated somewhat.

Id.

Amici agree with Respondents that the valuation misstatement penalties only apply to underpayments of tax that are caused by a taxpayer overstating the value of an asset. The Fifth Circuit's holding below should also be affirmed for the alternative reason

that it reflects the agency's own longstanding interpretation of the penalty statute.

In 1992, the IRS issued a "Litigation Guideline Memorandum," the purpose of which was "to outline the Service's current litigating position regarding the application" of the valuation misstatement penalties, as well as other penalties containing the phrase "attributable to." Litigation Guideline Memorandum TL-68 (Rev.), 1992 LGM LEXIS 14 (Aug. 12, 1992) ("LGM TL-68").[9] LGM TL-68 contains a thorough analysis of the valuation misstatement penalty statute, its legislative history, and the extant case law. LGM TL-68 remains in effect today; indeed, the IRS recently reiterated its continuing vitality. *See* I.R.S. Chief Couns. Notice CC-2012-001, 2011 CCN LEXIS 18 (Oct. 5, 2011) (discussing application of LGM TL-68 in connection with taxpayer concessions). As a thoughtful statement of agency position, LGM TL-68 is entitled to substantial deference under *Skidmore v. Swift & Co.*, 323 U.S. 134 (1944). "The fair measure of deference to an agency administering its own statute has been understood to vary with circumstances, and courts

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[9] LGMs "provide information and instruction relating to litigating procedures and methods, and standards and criteria on issues and matters of significant interest to litigating attorneys in the Office of Chief Counsel." *See* I.R.S. Ann. 99-81, 1999-32 I.R.B. 244 (quoting Chief Counsel Notice N(32)210-1 (April 18, 1988)). Although the government calls LGM TL-68 "non-binding," (Gov't Br. 48 n.9), it is a document that the IRS uses to train the thousands of IRS lawyers who are tasked with enforcing the tax laws. That it may be "non-binding" is hardly any reason not to accept it as a statement of the agency's position on the issue under consideration.

have looked to the degree of the agency's care, its consistency, formality, and relative expertness, and to the persuasiveness of the agency's position." *United States v. Mead Corp.*, 533 U.S. 218, 228 (2001) (citing *Skidmore*, 323 U.S. at 139-40).

LGM TL-68 essentially adopts the "Blue Book" formula as the appropriate means to determine "the portion of an underpayment that is 'attributable to' overvaluation." LGM TL-68, at *16-17 (citing STAFF OF JOINT COMM. ON TAX'N, 97TH CONG., GENERAL EXPLANATION OF THE ECONOMIC RECOVERY TAX ACT OF 1981 333 (Comm. Print 1981) (the "Blue Book")). The formula expressed in LGM TL-68 is:

> (1) calculate the amount of tax liability for each year as if all items had been reported properly; (2) without taking into account any adjustments that are attributable to the valuation overstatement (including adjustments which are inseparable from the overstatement issue), calculate the amount of tax liability as if all other items had been reported properly; and (3) calculate the difference between (1) and (2); the difference between (1) and (2) is the underpayment attributable to the valuation understatement.

LGM TL-68, at *16-17. LGM TL-68 explains that the "formal legislative history surrounding the enactment of section 6659A before its repeal by the Revenue Reconciliation Act of 1989 also supports the interpretation and the application of the formula," and that Treas. Reg. § 301.6621-2T, Q & A-5 applies an identical formula for purposes of determining the portion of an underpayment attributable to a "tax motivated transaction." *Id.*, at *17.

With respect to the specific issue being addressed here, LGM TL-68 explains that "[o]ne result of applying the formula is that where a taxpayer claims a deduction or credit that is disallowed for reasons unrelated to a valuation overstatement, none of the underpayment is attributable to the valuation overstatement, *even if there is also a valuation overstatement with respect to that same deduction or credit.*" *Id.*, at *17-18 (emphasis added). That interpretation is consistent with the statement in the Blue Book that the "portion of a tax underpayment that is attributable to a valuation overstatement will be determined after taking into account any other proper adjustments to tax liability." Blue Book at 333. Nothing in the statute or its legislative history suggests that the phrase "any other adjustments" does not include other adjustments to the deduction that could support the valuation misstatement penalty. LGM TL-68 therefore concluded that "[w]here a taxpayer claims a deduction or credit that is disallowed on grounds unrelated to a valuation overstatement, none of the underpayment is attributable to a valuation overstatement, even if the taxpayer also made a valuation overstatement with respect to that same deduction or credit." LGM TL-68, at *17. LGM TL-68 determined that the penalty should be imposed, however, "where the grounds for disallowing a deduction or credit are 'an integral part of or inseparable from' overvaluation," and it modified the Blue Book formula to reflect that position. *Id.*, at *15.

The government's main argument for imposing the penalty in this case must be rejected because it contradicts the IRS's longstanding interpretation of

the statute. The government argues that the Fifth Circuit misinterpreted the Blue Book because:

> The relevant passage describes a situation in which two *different* deductions are improper, one because of a basis overstatement and one for a separate reason. . . . In *Todd v. Commissioner*, 862 F.2d 540 (5th Cir. 1988), however, the court of appeals misinterpreted that passage to foreclose the overstatement penalty where the *same* deduction that reflects a basis overstatement is invalid on an alternative ground as well. *See id.* at 542-43. The *Blue Book* formula was not intended for that purpose, and the court's holding has no support in the statute's text.

(Gov't Br. 25.) In other words, the government's main argument in this case is that the penalty *should* apply where a deduction "reflects a basis overstatement" even though the deduction is disallowed on grounds unrelated to valuation. That argument must be rejected because it directly contradicts the IRS's interpretation (as expressed in LGM TL-68) that the penalty *should not* apply "where a taxpayer claims a deduction or credit that is disallowed for reasons unrelated to a valuation overstatement . . . even if there is also a valuation overstatement with respect to that same deduction or credit."[10] LGM TL-68, at *17-18. The IRS's

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[10] The government alternatively argues that the penalty should be imposed in this case because the "determination that COBRA lacked economic substance was not a ground for disallowance that was independent of the basis overstatement." (Gov't Br. 25.) As noted above, LGM TL-68 similarly finds that

considered, valid, longstanding interpretation under LGM TL-68 is entitled to significant weight. *See United States v. Mead*, 533 U.S. 218, 228 (2001) (citing *Skidmore*); *Reimels v. Comm'r*, 436 F.3d 344, 347-48 & n.2 (2d Cir. 2006) (citing *Skidmore* and following a longstanding Revenue Ruling in light of "the persuasiveness of its reasoning") *Rubie's Costume Co. v. United States*, 337 F.3d 1350, 1360 (Fed. Cir. 2003) (deferring under *Skidmore* to Customs classification ruling in light of "Customs's specialized experience"); *Heartland By-Products, Inc. v. United States*, 264 F.3d 1126, 1134 (Fed. Cir. 2001) (deferring under *Skidmore* to Customs revocation ruling because of its persuasiveness and Customs' "specialized expertise").

The IRS's interpretation as expressed in LGM TL-68 serves Congress's purpose for enacting the penalty. As LGM TL-68 explains, numerous taxpayers have conceded that an item is not deductible or creditable on grounds unrelated to value in order to avoid the valuation misstatement penalty. LGM TL-68, at *21-28. Until recently, the courts generally agreed that such concessions served the purpose of the penalty, and held that the penalty could not be imposed in those circumstances. *See Weiner v. Comm'r*, 389 F.3d 152, 161-63 (5th Cir. 2004); *McCrary v. Comm'r*, 92 T.C. 827, 851-55 (1989); *Rogers v. Comm'r*, 60 T.C.M. (CCH) 1386

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the valuation misstatement penalty should apply "where the grounds for disallowing a deduction or credit are 'an integral part of or inseparable from' overvaluation." LGM TL-68, at *15. Amici take no position on the government's alternative argument.

(1990); *Schachter v. Comm'r*, 67 T.C.M. (CCH) 3092 (1994).[11] As the Fifth Circuit explained in *Weiner*, imposing the penalty in that situation would conflict with the purpose of the penalty because it would do "nothing to relieve the Tax Court's backlog." *Weiner*, 389 F.3d at 163. *See also Schachter*, 67 T.C.M. at 3094 ("The objectives of administrative efficiency and judicial economy have been well served by the closing agreement and petitioner's concession. Those objectives would not be served by requiring a trial on the substantive issues for the sole purpose of determining whether petitioner is liable for [the increased interest penalty].")

LGM TL-68 likewise concluded that taxpayer concessions serve Congress's goal for enacting the valuation misstatement penalty, and instructs all IRS attorneys to analyze taxpayer concessions under the following framework:

> [W]here a taxpayer establishes that a deduction or credit is not allowable for reasons unrelated to valuation or a tax motivated transaction, it follows that sections 6659[12] and 6621(c) should not be imposed with respect to the underlying underpayment, if the taxpayer

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[11] Some of these cases analyzed the now-repealed "tax motivated" interest penalty. These cases are instructive because "both [penalties] employ the same 'attributable to' language." *Weiner*, 389 F.3d at 160.

[12] Section 6659 was the predecessor to Section 6662. *See* Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248, § 323(a), 96 Stat. 324, 613-15; Tax Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, § 722(a)(1), 95 Stat. 172, 341-43.

timely concedes the deduction or credit prior to trial on a ground "independent of and wholly separable from" overvaluation or a tax motivated transaction.

However, where, in order to avoid the sanctions of sections 6659 and 6621(c), a taxpayer concedes, post-trial, a ground for the disallowance of deductions and credits that does not involve a finding of overvaluation or a tax motivated transaction, the concession should be rejected. We believe that the distinctions made by the Tax Court between pre-trial and post-trial are valid ones. Concessions, as all pleadings, should be timely made in order to avoid protracted and costly proceedings. Where respondent has undertaken extensive preparations and has gone through a trial, respondent should oppose concessions that limit the taxpayer's exposure. Counsel should argue that the court, in its discretion, should determine all issues tried, including those making applicable the sections 6659 and 6621(c) additions. This position, we believe, is consistent with the legislative intent of sections 6659 and 6621(c). *The legislative history of sections 6659 and 6621(c) suggests that Congress enacted those sections to provide the court tools for managing the large backlog of valuation and tax shelter cases. Consistent with this, the taxpayer's concession should be timely to avoid trial.*

LGM TL-68, *29-30 (emphasis added).[13]

Some courts have recently held, however, that a taxpayer may not avoid imposition of the penalty by conceding a deduction on grounds unrelated to value. These courts accepted the same legally erroneous contention that the government makes here: that the Blue Book formula purportedly only addresses the appropriate computation in cases involving two or more unrelated deductions. *See Alpha I, L.P. v. United States*, 682 F.3d 1009, 1029-30 (Fed. Cir. 2012); *Gustashaw v. Comm'r*, 696 F.3d 1124, 1136-37 (11th Cir. 2012) (dicta); *AHG Invs., LLC v. Comm'r*, 140 T.C. No. 7 (2013). The Tax Court recognized that this "may reduce the number of cases conceded by taxpayers attempting to avoid gross valuation misstatement penalties" and "lead to more trials on questions of valuation," but determined that "concerns relating to judicial economy are not a sufficient reason to disregard or continue to incorrectly apply the clear formula and example in the Blue Book." *AHG Invs.*, 140 T.C. No. 7, 2013 WL 999916, at *8 & n.12. Indeed, to continue to impose this penalty when the taxpayer has conceded the

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[13] The IRS Chief Counsel recently confirmed the continuing vitality of the LGM but advised IRS lawyers that it is their responsibility to oppose purportedly "abusive" concessions. *See* IRS Chief Couns. Notice CC-2012-001. The Notice does not explain, however, what causes a particular concession to be "abusive", in light of LGM TL-68's careful finding that concessions serve Congress's purpose "to provide the court tools for managing the large backlog of valuation and tax shelter cases." LGM TL-68, at *30. In any event, trial courts are not required to accept "abusive" concessions. *See, e.g.*, Fed. R. Civ. P. 15(a)(2).

underlying adjustment will have exactly the opposite of Congress's intended effect because taxpayers will have nothing to lose by continuing to litigate and forcing the courts to decide difficult valuation issues—exactly what Congress was trying to avoid. That will place a significant burden on trial courts because it *requires* them to determine whether *any* ground that the IRS raises in support of an adjustment could support the penalty, and also because valuation issues are generally not susceptible to summary judgment.

The position urged by the government in this case has accordingly caused certain courts to *apply* the penalty in a manner that defeats the purpose *of* the penalty.[14] This Court should fix what the government has broken. It should affirm the judgment of the court of appeals because it accords with the agency's own interpretation of the penalty statute whereas the government's position frustrates the purpose of the statute.

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[14] The government concludes by claiming that it would unfair to impose the valuation misstatement penalty on "taxpayers who make simple errors in computing their bases in property" and not to impose it in this case. (Gov't Br. 49.) The penalty would not be imposed on taxpayers who make simple errors because the Code exempts from the penalty any understatement for which the taxpayer acted reasonably and in good faith. *See* Section 6664(c).

CONCLUSION

Amici respectfully request that the Court find that the district court lacked jurisdiction, in a partnership proceeding, to consider penalties that are predicated on an adjustment to outside basis, and accordingly remand the case with orders to dismiss. If the Court finds that jurisdiction exists to consider the valuation misstatement penalties in this case, Amici respectfully request that the Court find that the valuation misstatement penalty may not be impose where the IRS has completely disallowed the underlying loss for reasons unrelated to value.

* * * * * * *

Respectfully submitted,

THOMAS A. CULLINAN
Counsel of Record
N. JEROLD COHEN
SUTHERLAND ASBILL & BRENNAN LLP
999 Peachtree Street, NE
Atlanta, Georgia 30309
(404) 853-8000
tom.cullinan@sutherland.com

July 26, 2013

Counsel for Amici Curiae New Millennium Trading, LLC, AHG Investments, LLC, NPR Investments, LLC, Alpha I, L.P., and West Ventures, L.P.

AMICUS CURIAE BRIEF

RECORD
AND
BRIEFS

Supreme Court, U.S.
FILED
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No. 12-562

In the Supreme Court of the United States

UNITED STATES,

Petitioner,

v.

GARY WOODS, AS TAX MATTERS PARTNER OF TESORO DRIVE PARTNERS, *ET AL.*,

Respondents.

On Writ of Certiorari to the United States Court of Appeals for the Fifth Circuit

BRIEF OF AMICI CURIAE PARTNERS IN JADE TRADING, LLC, PETALUMA FX PARTNERS, LLC, AND TIGERS EYE TRADING, LLC IN SUPPORT OF RESPONDENTS AND JURISDICTIONAL REVERSAL

David D. Aughtry
Counsel of Record
CHAMBERLAIN, HRDLICKA,
WHITE, WILLIAMS & AUGHTRY
191 Peachtree Street, N.E.
Thirty-fourth Floor
Atlanta, GA 30303
(404) 659-1410
david.aughtry@chamberlainlaw.com

Edward M. Robbins, Jr.
HOCHMAN, SALKIN, RETTIG,
TOSCHER & PEREZ, P.C.
9150 Wilshire Boulevard
Suite 300
Beverly Hills, CA 90212
(310) 281-3247
EdR@taxlitigator.com

Counsel for Amici Curiae

Becker Gallagher · Cincinnati, OH · Washington, D.C. · 800.890.5001

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QUESTION PRESENTED[1]

Whether penalties that require the determination of the partner-level "outside basis" that partners report on their individual returns fall within partnership jurisdiction under Section 6226(f) or partner-level "affected item" deficiency jurisdiction under Section 6230(a)(2)(A) – that is, partner-level proceedings where the partners can defend themselves.

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[1] Due to the overriding importance of jurisdiction, this Court raised the jurisdictional question *sua sponte* and framed it as: "Whether the district court had jurisdiction in this case under 26 U.S.C. § 6226 to consider the substantial valuation misstatement penalty." The same jurisdictional defects apply to any penalty imposed on the differing basis of the various partners in their partnership interests (commonly known as "outside basis") and so, we have stated the issue in terms of its natural breadth.

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INTEREST OF *AMICI CURIAE*[2]

All three sets of partners in *Jade*, *Petaluma*, and *Tigers Eye* face the IRS imposing penalties on a partner at the partnership level before he can defend himself. That advantage remains so important to the IRS that it has subjected *Petaluma* to a repetitive second appeal, subjected *Jade* to a repetitive second appeal, and has now asserted three stacked levels of tax (and penalties) on the same income reported by three of the five *Jade* partners. The two Tax Court opinions in *Tigers Eye* embody that tactic: the first bars the partners from presenting their reasonable cause defense on the grounds the Tax Court lacks partnership jurisdiction over partner-level defenses and the second, by way of *dicta*, purports to reject their reasonable cause defense on the merits. All *amici* seek a fair trial on their deferred Section[3] 6664(c) reasonable cause defenses in these 13 year old cases. Thus, the three sets of *amici* partners have a continuing direct interest in the jurisdictional issue which neither the trial nor Circuit Court addressed in *Woods I* and *II*. Neither litigant in this case addresses all the jurisdictional considerations addressed herein.

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[2] Counsel of record for all parties graciously consented in writing to the filing of this *amici* brief. No counsel for a party authored this brief in whole or in part, and no counsel or party made a monetary contribution intended to fund the preparation or submission of this brief. No person or entity other than *amici curiae*, its members, or its counsel made a monetary contribution to its preparation or submission.

[3] Unless otherwise indicated, "Section" references are to 26 U.S.C., which correspond to sections in the Internal Revenue Code of 1986 (as amended through December 27, 1999).

SUMMARY OF ARGUMENT

Twice before the Federal Circuit in *Jade Trading II* and *IV* and twice before the D.C. Circuit in *Petaluma II* and *VI*, the IRS sought to secure the great advantage of punishing former partners at the partnership level based on *the contents of their individual returns* AND simultaneously barring those partners from defending themselves. In each instance, the IRS pressed this "flog-'em-now/try-'em-later" tactic by glossing over the same three critical distinctions that the IRS glosses over here.

One, the IRS glosses over the reality that it does not seek to impose what it calls "the basis overstatement penalty" on any tax basis reported on the partnership return and it does not seek to impose that penalty on affected items that require no further partner-level determination under Section 6230(a)(1). No, the IRS seeks to impose its "basis overstatement penalty" at the partnership level on the "outside basis" that the departed partners report solely on their returns. As four Courts of Appeal held, that outside basis constitutes an affected item which requires the partner-level determinations that Section 6230(a)(2) preserves for the partner-level deficiency proceeding.

Two, the IRS glosses over here, as it did in *Petaluma II-IV* and *Jade II-IV*, the distinction between the traditional posture of penalties *as* an affected item and the imposition of penalties *on* affected items that still require a subsequent partner-level deficiency proceeding.

And three, the IRS glosses over its extraordinary attempt to usurp both the partnership-level and the partner-level deficiency jurisdiction *of the courts*. As amended in 1997, Section 6226(f) grants "*a court* [not the IRS] ... jurisdiction to determine *all partnership items of the partnership for the partnership taxable year* [not the affected items the former partners reported on their returns for their taxable years]...and *the applicability of any penalty* [that is, the essential elements of that penalty] which relates to *an adjustment* [not an abstract conceptual determination (like sham) not listed on the FPAA "Schedule of Adjustments": J.A. 91, 145]; to *a partnership item* [not the outside basis the IRS admits requires a partner-level proceeding]."

The IRS then obliterates the jurisdictional integrity of the Section 6230(a)(2)(A) partner-level affected item judicial proceeding by stretching the "computational adjustment" stage beyond its computational function. With no judicial participation at that stage, the IRS (i) unilaterally resolves all remaining essential elements of the penalty against the partner, (ii) preempts the partner-level judicial proceeding by determining each former partner's respective "outside basis," resulting loss, and resulting deficiency on his individual return, (iii) preempts any consideration of his reasonable cause (which Section 6664(c) contemplates must be determined before imposition of any Section 6662 penalty), and (iv) finally imposes, assesses, and demands payment of that penalty before the partner can defend himself. The IRS usurps the heart of the affected item deficiency jurisdiction Congress took such care to preserve.

Facing that jurisdictional trespass, the D.C. Circuit rejected the attempt by the IRS in *Petaluma II* to pick the affected-item "forbidden fruit" before its time. The Federal Circuit adopted that reasoning and much of its language in *Jade II*. The trial courts in *Petaluma III* and *Jade III* faithfully followed that reasoning on remand. The Federal Circuit promptly rejected the IRS repetitive appeal in *Jade IV*, while the repetitive IRS appeal in *Petaluma VI* awaits decision. Those repetitive appeals herald how badly the IRS wants this "flog-'em-now/try-'em-later" advantage. Worse, the IRS now contends that imposition of the defense-barred penalty is "conclusive" and "unreviewable." IRS Br. 35.

The decisions by those two Courts of Appeal follow the same affected-item-deficiency reasoning adopted by two other Courts of Appeal at the urging of the IRS when the shoe was on the other foot. *Desmet v. Commissioner*, 581 F.3d 297, 304-5 (6th Cir. 2009) (despite purported elimination of outside basis via sham determination at the partnership level, outside basis remained an affected item that required partner-level deficiency procedures under Section 6230(a)(2)(A)); *Napoliello v. Commissioner*, 655 F.3d 1060, 1064 (9th Cir. 2011) (same holding). Citing *Desmet*, the D.C. Circuit in *Petaluma II* specifically rejected the IRS argument urged here that penalties can be imposed on outside basis because "elements" of outside basis are partnership items. The D.C. Circuit in *Petaluma II* (and Federal Circuit in *Jade II*) concluded that "the fact that a determination seems obvious or easy does not expand the court's jurisdiction ... no matter how low the fruit hangs..." *Id.*, 591 F.3d at 654-5.

With no conflict from any other Court of Appeals, these cases lead to this workable, three-prong jurisdictional rule that maintains the integrity of partnership jurisdiction, the computational function of the "computational adjustment," and partner-level affected item deficiency jurisdiction:

* A Section 6662 "Accuracy-Related Penalty on Underpayments" can be imposed at the partnership level on *adjustments* to partnership items on the partnership return (such as partnership gains and losses) that generate underpayments which can be computed with no need for a partner-level deficiency proceeding.

* Where no partner-level determination is required, the resulting underpayment and penalty can be calculated and assessed purely as a Section 6230(a)(1) "computational adjustment."

* Conversely, no Section 6662 "Accuracy-Related Penalty on Underpayments" can be imposed at the partnership level on an underpayment that cannot be computed without the Section 6230(a)(2)(A) partner-level deficiency proceeding: those penalties must be asserted in that proceeding where the partner can defend himself.

That three-prong reconciliation cures the practical and jurisdictional impossibility the IRS FPAAs raise in *Woods*. Those FPAAs disregard the partnership and treat the transactions as "engaged in directly by its purported partners." [J.A. 93, 147] Their basis in the distributed assets and any resulting deficiency and penalty can only be determined in their deficiency proceedings.

Coupled with another draconian device, the IRS tactic of imposing outside basis penalties on the partners at the partnership level before they can defend themselves will mean that many people *will never be able to defend themselves*. The IRS seeks to assess those penalties as a "computational adjustment" under Section 6230(a)(1) "without following deficiency procedures." IRS Br. 23. In such cases, no prepayment forum exists for challenging the IRS's summary determination. Instead, a partner who wishes to challenge such an assessment may only do so in a tax refund suit, and then only if the partner is able to pay the penalty in full *within six months of the date the IRS mails the notice of computational adjustment* to the partner. 26 U.S.C. § 6230(c)(1), (2)(A). *See Flora v. United States*, 362 U.S. 145, 177 (1960).

This truncated tax refund procedure under TEFRA should be contrasted with the far more taxpayer friendly procedures for the traditional tax refunds under the Code. *See* Subchapter B -- Limitations on Credit and Refund of Chapter 65 -- Abatements, Credits, and Refunds (26 U.S.C. §§ 6511-6515). Under the IRS argument, that same notice of computational adjustment contains the assessment and demand for payment of the full taxes (including the outside basis component), interest on the taxes, the 40 percent penalty, and here, 13 years of interest on the penalty. If those former partners are unable to pay those defense-barred penalties within those six months, their defenses will be barred forevermore.

ARGUMENT

By way of a brief overview of the substantive and procedural foundation for these cases, the Internal Revenue Code treats partnerships as pass-through entities which pass their tax consequences onto their partners. 26 U.S.C. § 701. The partnership files a U.S. Partnership Information Return (Form 1065) reporting those consequences and the individual partners file their own returns reporting their distributive shares of those consequences.

Of significance here, each partner takes a tax basis in his or her partnership interest (commonly referred to as that partner's "outside basis") which is generally calculated as the sum of cash and the partner's cost basis in any assets contributed to the partnership. 26 U.S.C. §§ 705, 722, 1012. *Importantly, the U.S Partnership Information Return provides no space or box for the partnership to report the varying outside basis of the different partners. Only the partners' returns reflect outside basis and then only occasionally.* The typical situation arises when a partner redeems his partnership interest for distributed assets. Section 732(b) determines the basis of those assets in his hands by substituting his outside basis for whatever basis the partnership may have had in those assets prior to distribution (the partnership's "inside basis").[4] When the former partner later sells some or all of the distributed assets, he reports the sales proceeds, his (outside) basis in those assets, and the resulting gain or loss on his return.

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[4] The *Woods* partnership termination operates as a redemption, distribution, and recontribution to the S Corporation.

The substantive dispute (which the trial and appellate courts did not reach in *Woods* due to their economic substance holding) emanates from the prevailing law in 1999 as to contingent obligations. For over 50 years, the IRS successfully applied that authority to exclude contingent obligations as falling short of fixed liabilities.[5] *Woods* and the *amici* cases involve individuals who were advised to acquire long (purchased) and short (sold) foreign currency options and contribute the long option to a partnership in exchange for a partnership interest. The partners in these partnerships received lengthy opinions from large law firms and/or accounting firms advising the partner's local CPA to include the cost of the purchased option in his outside basis and to exclude the contingent short option.

The IRS audited the partnership returns and proposed adjustments in a Final Partnership Administrative Adjustment ("FPAA"). The two FPAAs issued in *Woods*, like all FPAAs, contain an "Explanation of Items" and a "Schedule of Adjustments." While the *Woods* "Explanation" contains abstract sham assertions, the *Woods* "Schedule of Adjustments" contains *no adjustment to the capital contributions or distributions reported on the partnership return.* [J.A. 91, 145] With no numerical adjustment, it improperly lists the affected-item outside basis as a partnership item.

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[5] Among many others, those cases include *Deputy v. du Pont*, 308 U.S. 488, 497 (1940) (short sale held contingent obligation); *Long v. Commissioner*, 71 T.C. 1, 10-12 (1978) (partnership basis excludes contingent obligation); *LaRue v. Commissioner*, 90 T.C. 465, 480-82 (1988) (same); *Helmer v. Commissioner*, T.C. Memo 1975-160 (1975) (same).

The IRS filed this appeal in an attempt to impose what it calls the "basis overstatement penalty"[6] *at the partnership level* on the "outside basis" which individual partners report on their returns and which the IRS admits constitutes an affected item. IRS Br. 33-4. The IRS asserts on brief that adjustments to the capital contributions and distributions on the partnership return provide the partnership-item foundation for imposing the "basis overstatement penalty." Not only does the FPAA "Schedule of Adjustments" contain no such adjustments, the partnership return reports those items under rules that do not affect outside basis.

This penalty remains at least four steps removed from the partnership, as the Court confirmed in *Jade III*.[7] Finally, the IRS insistence upon penalizing the outside basis affected-item at the partnership level exploits the *Tigers Eye I* ruling, barring those partners from defending themselves at that level.

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[6] While outside the scope of this brief, the IRS stretches the "*Substantial Valuation Misstatement*" penalty (26 U.S.C. § 6662(e)) beyond its limits for the reasons summarized in *Woods* Arg. II. *Amici* agree with that analysis.

[7] Those steps include: (i) the partnership distributes assets to a partner in redemption of his partnership interest (here, a constructive redemption and distribution upon the termination of the *Woods* partnerships), (ii) after the distribution, Section 732(b) substitutes outside basis as the asset basis in the hands of the former partner, (iii) the outside basis (reported on the individual return) results in a subsequent gain or loss (reported on the individual return) when the partner later sells it, (iv) the gain or loss dictates the tax liability, and (v) that liability (along with any Section 6664(c) reasonable cause) determines the applicability of the Section 6662 percentage penalty.

A. CONGRESS CREATED THREE DISTINCT LEVELS OF JURISDICTION: PARTNERSHIP, COMPUTATIONAL ADJUSTMENT, AND PARTNER-LEVEL "AFFECTED ITEM" DEFICIENCY JURISDICTION.

In 1982, Congress adopted the Uniform Partnership Procedures (26 U.S.C. §§ 6221-6231) as part of the Tax Equity and Fiscal Responsibility Act of 1982 (Pub. L. 97-248: "TEFRA"). Those procedures created three distinct levels for the resolution of partnership and partner tax disputes:

(i) The partnership level proceeding under Sections 6221 and 6226(f) – deals exclusively with "partnership items" (and is jurisdictionally barred from determining any partner-level affected item or other nonpartnership items);

(ii) The computational adjustment assessment proceeding under Section 6230(a)(1) – implements partnership adjustments by assessing any change in the partners' tax liability that does not require additional partner-level determinations; and

(iii) The partner-level "affected item" deficiency proceeding under Section 6230(a)(2) – required when partner-level determinations are needed.

In 1997, Congress expanded partnership proceedings under Section 6226(f) to include "the applicability of any penalty ... which relates to an adjustment to a partnership item." Taxpayer Relief Act of 1997, Pub. L. No. 105-34, § 1238, 111 Stat. 788, 1026.

Section 6230 distinguishes between the normal circumstance (adjustments to items on partnership returns that result in tax consequences that can be computed and assessed with no need for partner-level proceedings) and circumstances such as this (unresolved affected items that require a partner-level proceeding to determine a deficiency – and any penalty on that deficiency). Where the partnership item adjustment yields a deficiency with no need for partner-level determinations, the IRS assesses applicable penalties against a partner. He can only contest them by paying and suing for a refund – akin to forcing a defendant to pay punitive damages before defending himself.

Conversely, penalties that relate to an adjustment to an affected item must be addressed in the partner-level affected item proceeding. *Jade II*, 598 F.3d at 1380.[8] *See also, Petaluma II*, 591 F.3d at 655. Hence, *Petaluma II* and *Jade II* honor the Congressional mandate in Section 6230(a)(2) that determining any underpayment (on which the Section 6662 underpayment penalty is based) must await conclusion of the partner-level affected item proceeding; it respects the delineation between the two types of affected items (Temp. Reg. §§ 301.6231(a)(6)-1T(a)(1) and (a)(2)); and it avoids requiring a trial court to do the impossible. No trial court should be asked to determine the applicability of a percentage-penalty to an affected item that, as a jurisdictional matter, cannot be determined yet.

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[8] *Jade II* better illustrates the select partner aspect than *Woods*: on the same arguments pressed here, the IRS tried to penalize the outside basis of only three out of five partners.

B. THE IRS SEEKS TO USURP JUDICIAL AUTHORITY AT BOTH THE PARTNERSHIP AND PARTNER LEVELS.

Under Sections 6226(f) and 6230(a)(2), the Courts – not the IRS – possess jurisdiction to determine the applicability of penalties that relate to adjustments to partnership items (at the partnership level) and to affected items which require a deficiency proceeding (at the partner level). *Petaluma II*, 591 F.3d at 155-56. Yet, the IRS usurps the judicial authority at both levels so that the IRS can impose penalties on select partners while the IRS regulations bar them from defending themselves.

The IRS first seeks to usurp the authority of the Court at the partnership level by not asking the Court to determine the "applicability" of the Section 6662 Accuracy-Related Underpayment Penalty. No, the IRS asks the Court only to offer an abstract (declaratory) opinion as to one element of the penalty (say sham), even though neither the underpayment nor the penalty can be computed without outside basis and even though the IRS admits that outside basis constitutes a partner-level affected item that requires a partner-level deficiency proceeding. From that springboard, the IRS bestows upon itself the jurisdiction to determine all other elements of the Section 6662 penalty at the "computational adjustment" stage – including determination of the "forbidden fruit" (the partner's outside basis, resulting loss, and deficiency). IRS Br. 18. In sum, the IRS usurps both levels of judicial authority so it can punish the partner on forbidden fruit while *Tigers Eye I* gags him.

1. The Analysis Begins with the Section 6226(f) "SCOPE OF JUDICIAL REVIEW".

Section 6226(f) bestows partnership jurisdiction upon trial courts as follows:

> SEC. 6226. JUDICIAL REVIEW OF FINAL PARTNERSHIP ADMINISTRATIVE ADJUSTMENTS.
>
> * * *
>
> (f) SCOPE OF JUDICIAL REVIEW.—***A court*** with which a petition is filed in accordance with this section ***shall have jurisdiction to determine*** all partnership items of the partnership for the partnership taxable year ... and ***the applicability of any penalty*** ... which relates to ***an adjustment to a partnership item***. (Emphasis added).

Thus, partnership penalty jurisdiction depends upon three conjunctive elements. One, Congress bestowed the "jurisdiction to determine" the penalty upon "a court," not the IRS. Two, the court possesses the jurisdiction to determine "the applicability" of the penalty. And three, the applicable penalty must "relate to an adjustment to a partnership item" – not to a naked "partnership item" (void of any adjustment) and not "to an adjustment to an affected item". Rather than focus upon the operative words, the IRS devotes most of its energies to the transitional reference which applies with equal ease to the category Congress did not include in partnership jurisdiction – "relates to an adjustment to an affected item." *Petaluma II*, 591 F.3d at 655.

2. Congress Bestowed Partnership Jurisdiction Upon "A *Court* ... to Determine the *Applicability* of [the Section 6662] Penalty" – Not Upon the IRS.

Section 6226(f) bestows partnership jurisdiction upon "*a court* ... to determine *the applicability*" of any penalty ..." – not the IRS. The "applicability" of the Section 6662 "IMPOSITION OF ACCURACY-RELATED PENALTY ON UNDERPAYMENTS" starts with Section 7491(c), which imposes the burden of production for any penalty on the IRS to establish a *prima facie* case. 26 U.S.C. § 7491(c); *Higbee v. Commissioner*, 116 T.C. 438, 449 (2001) (Section 7491(c) requires IRS to produce sufficient evidence to establish essential elements of *prima facie* case). If one essential element fails, no penalty is "applicable." The essential elements of the penalty include (i) an inaccuracy, (ii) reported on the partnership return, (iii) as to an item that could create an underpayment,[9] (iv) prohibited conduct such as negligence, (v) a tax deficiency resulting from that conduct, and (vi) lack of substantial authority and/or a reasonable belief as to the likely accuracy.

The question arises: "applicable" to what? The IRS first says "outside basis." However, no "basis overstatement penalty" can be "applicable" to "outside basis" at the partnership level because the partnership return contains no accurate or inaccurate statement of outside basis.

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[9] Many non-income/deduction items on a partnership return cannot create an understatement or support a penalty, such as identifying information, balance sheet content, and Schedule M-2 capital account data (including capital contributions).

Moreover, the partnership returns accurately reported the two alternate items which the IRS raises for the first time on brief (the capital contributions and the distributed assets). Indeed, those reported items do not affect outside basis.[10]

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[10] The partnership return drafted by the IRS requires that the partnership report the "capital contributions" in the "Schedule M-2 Capital Account" section. That section uses financial accounting principles that govern capital accounts to report capital contributions based on net fair market value (net of obligations like the contingent short option obligation) – not tax basis. LARRY E. RIBSTEIN & ROBERT R. KEATINGE, LIMITED LIABILITY COMPANIES § 17:10 fn. 29 (2 ed., West 2012) ("The contributing partner only receives an increase in the capital account for the net fair market value of the property contributed"); LAURA E. CUNNINGHAM & NOEL B. CUNNINGHAM, THE LOGIC OF SUBCHAPTER K 32 (2d ed., West Group 2000); *Mitchell v. Commissioner*, T.C. Memo 1997-382, 1997 WL 473178 at *3, n.5, *citing* Treas. Reg. §§ 1.705-1(a)(1), 1.704-1(b)(2)(iv)(b). The net fair market value considers the contingent obligations which outside basis excludes. 1 WILLIAM S. MCKEE ET AL., FEDERAL TAXATION OF PARTNERSHIPS AND PARTNERS 7-20 (4th ed., W.G.&L. 2007) ("[w]here real property is burdened by a contingent obligation ... the obligation is real and affects the value of the property. However, because it is contingent, incurring the obligation does not add to the basis of the property ... the obligation is not a 'liability' under Regulations § 1.752-1(a)(4)(i)"); *Deputy*, 308 U.S. at 494-95 (short option is not an indebtedness); *LaRue*, 90 T.C. at 480-82; *Helmer*, T.C. Memo 1975-160 (IRS established that short option excluded from Section 752 liability).

The Form 1065 reports distributed assets at Schedule K (line 23) at the partnership's "inside basis" (generally the cost the partnership paid for those assets). Form 1065 Instructions; 26 U.S.C. § 1012. As noted, Section 732(b) substitutes the "outside basis" for the distributed asset basis in the hands of the former partner. Consequently, neither the reported capital contributions nor the "inside basis" have any effect on the "outside basis," the resulting loss, or any underpayment.

Like so many information items on partnership information returns, they cannot possibly create an underpayment here. The IRS also points to no inaccuracy in the reported net fair market value of the contributions or the cost basis of the distributed assets.

Even when one disregards the partnerships and "treats the transactions as if they were engaged in directly by its purported partners" as the FPAA asserts (and the District Court sustained), the net fair market value of the capital contributions still makes no difference and the cost basis of the distributed assets reported on the partnership return remains the same amount. The FPAA "Schedule of Adjustment" contains no "adjustment" to the capital contributions and distributions reported on the partnership return, because they are neither mathematically relevant to any understatement/ deficiency nor inaccurate.

The IRS in essence asks this Court to hold that "applicability" does not mean "applicable" in the sense the "court" considers the (*prima facie*) essential elements. The IRS asks the court to only make an abstract threshold determination at the partnership level as to sham or negligence The IRS brief leaves no doubt as to whom the IRS advocates as the arbiter of all the remaining essential elements – why, the IRS, of course, at the so-called "computational adjustment" stage. IRS Br. 13, 28-29. The IRS couples that tactic with other draconian devices to gag the defenses of many taxpayers forever.

The government argues at page 13 of its brief:

> "Once partnership-level proceedings conclude, *the IRS evaluates* partners' individual returns in light of the partnership-level adjustments. ... *the IRS may assess* penalties against individual partners immediately through computational adjustments without issuing a notice of deficiency. See 26 U.S.C. 6230(a)(2). A partner may then file a refund claim ... Again, however, any determination by the FPAA or by a court in a partnership-level proceeding regarding the applicability of the penalty is 'conclusive' ... " (Emphasis added).

Computational adjustments that do not require any partner-level determinations are exempt from the deficiency procedures, and therefore are assessed without the prior issuance of a notice of deficiency. 26 U.S.C. § 6230(a)(1). In such cases, there is no prepayment forum for challenging the IRS's summary determination. Instead, a partner who wishes to challenge such an assessment may only do it in a tax refund suit, but only if the partner pays the penalty in full within six months of the date the IRS mailed the notice of computational adjustment to the partner. 26 U.S.C. § 6230(c)(1), (2)(A). *See Flora v. United States*, 362 U.S. 145, 177 (1960). This truncated tax refund procedure under TEFRA should be contrasted with the far more taxpayer friendly procedures for the traditional tax refunds under the Code. *See* Subchapter B -- Limitations on Credit and Refund of Chapter 65 -- Abatements, Credits, and Refunds (26 U.S.C. §§ 6511-6515).

3. The "*Applicability*" of a Penalty to "an *Adjustment to a Partnership Item*" Does Not Mean an Abstract Concept Nor "an *Adjustment to an Affected Item.*"

The D.C. Circuit in *Petaluma II*, and the Federal Circuit in *Jade II* and *IV*, resolved the critical question here: is a Section 6662 underpayment penalty "applicable" to "an adjustment to a partnership item" OR to "an adjustment to an affected item" where the underpayment requires a partner-level affected-item proceeding under Section 6230(a)(2)? With no conflict from any other circuit, both the D.C. Circuit and the Federal Circuit harmonized the Section 6226(f) partnership jurisdiction and Section 6230(a)(2) partner-level jurisdiction in the most practical way – where the underpayment penalty cannot be computed without a partner-level proceeding, its "applicability" must await the partner-level proceeding.

That resolution by the consistent circuit authority comports with Section 6230(a) which coordinates the partnership-level proceedings with the partner-level proceedings. Subsection (a)(1) permits the IRS to assess "computational adjustments" against the partners without resorting to the Subchapter B deficiency procedures – "[e]xcept as provided in paragraph (2) or (3)." Section 6230(a)(2) guarantees the partner that right to trial under the deficiency procedures on the affected items which require partner-level determinations. The Subchapter B deficiency procedures bar any assessment until after IRS issues a notice of deficiency and the taxpayer exhausts his right to trial. 26 U.S.C. §§ 6211, *et seq.*

Section 6230(a)(2) tracks Section 6226(f) by only excluding penalties that relate to adjustments to partnership items – *not penalties that relate solely to partnership items with no adjustment nor to affected item adjustments*. That provokes three observations.

First, the IRS attempt to reduce the numerical "adjustment" to statutory surplusage trailing an abstract partnership item must fail. The word, statute, and context confirm that "adjustment" remains a concrete numerical act within the tax code. Abstract concepts like sham may constitute "partnership items" but Congress did not incorporate "penalt[ies] that relate to partnership items" into partnership jurisdiction: Congress only incorporated "penalt[ies] that relate to *adjustments* to partnership items." The "applicability" of those numerically-driven "penalties" requires a numerical "adjustment." TEFRA uses the same numerical "adjustment" standard in the Section 6227 "Administrative *Adjustment* Request" – which the IRS itself recognizes as numerical in nature. Internal Revenue Manual pt. 8.19.7.2 (March 9, 2009). The "Schedule of Adjustments" in the two *Woods* FPAAs prove the same point. While that Schedule improperly uses the non-numerical asterisk reference to "Outside Partnership Basis," the Schedule calls for a numerical "adjustment" and the remaining "Schedule of Adjustments" is limited to reversing the numerical income reported by the two partnerships (totaling $700,000). This Section 6226(f) concrete "adjustment" requirement fulfills the essential role of setting the stage for the next act under the TEFRA procedures – the numerical "computational adjustment."

Second, the "outside basis" foundation for what the IRS recasts as its "basis overstatement penalty" constitutes an "affected item" that requires a partner-level deficiency proceeding under Section 6230(a)(2). All four Courts of Appeal to address this issue agree that outside basis constitutes an affected item requiring a deficiency proceeding. The IRS again concedes here, as it conceded in *Petaluma II*, *IV*, and *VI* and in *Jade II* and *IV*, that "outside basis" constitutes such an "affected item."[11]

Third, the IRS itself established in *Desmet* the opposite of what it argues here. It matters not that part or all of the components of outside basis consists of "partnership items": it remains an "affected item" which must await the partner-level proceeding. *Desmet*, 581 F.3d at 304. Relying on *Desmet*, the D.C. Circuit rejected the IRS "elements" argument:

> On appeal the Commissioner concedes that outside basis is not a partnership item in this case. Instead, he asserts that outside basis is an affected item whose *elements* are mainly or entirely partnership items. He maintains that the Tax Court had jurisdiction to state the "obvious conclusion" that a partner cannot have any basis in a disregarded partnership. The correctness of this conclusion is immaterial, however, for the question is not whether the Tax Court's determination was correct, but whether the Tax Court had jurisdiction to make that determination at all in this partnership-level proceeding.

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[11] That concession renders the IRS dominant reliance on the thin plurality opinion in *Tigers Eye II* (6-3-6) curious.

* * *

> Under § 6226(f), the Tax Court had jurisdiction to determine partnership items, but it did not have jurisdiction to determine affected items. We have already rejected the Tax Court's conclusion that outside basis was a partnership item in this case, and we likewise reject the Commissioner's contention that outside basis, although it is an affected item, could nonetheless be determined in the partnership-level proceeding. The fact that a determination seems obvious or easy does not expand the court's jurisdiction beyond what the statute provides. In other words, ***it does not matter how low the fruit hangs when one is forbidden to pick it.*** *Petaluma II*, 591 F.3d at 654-5 (emphasis added).

Despite embracing "the larger statutory context" and "the threshold determination" (IRS Br. 13, 28), the IRS refuses to draw the "larger statutory context" threshold distinction between (i) no "adjustment," (ii) "adjustments" to partnership return items that cannot possibly create a Section 6662 Underpayment here (such as capital contributions and distributed asset "inside basis"), (iii) "adjustments" to partnership return items that create a Section 6662 Underpayment with no need for a partner-level affected-item deficiency proceeding, and (iv) "adjustments which relate to affected items" which require partner-level deficiency proceedings. *Petaluma II*, 591 F.3d at 654-55.

4. The IRS Arguments Would Obliterate the Category of Penalties That Relate to an Adjustment to Affected Items Which Require a Partner-Level Proceeding.

Contrary to *Petaluma II*, *Jade II*, and the underlying statutes, the IRS seems to categorically deny the existence of penalties that are applicable/relate to affected items which require partner-level proceedings under Section 6230(a)(2). That view contravenes the Commissioner's own regulations. In its 1999 temporary form (and now in its final form), the same regulation that the IRS cites at pages 32-33 as compelling the IRS concession that outside basis constitutes an affected-item – has also recognized since 1987 that penalties constitute affected items. Temp. Reg. § 301.6231(a)(5)-1T(b) casts outside basis as an affected-item and then subsection (d) casts all penalties as affected items:[12]

> (d) *Additions to tax or additional amount*—(1) *In general.* The term "affected item" includes any addition to tax or additional amount provided by subchapter A of chapter 68 of the Internal Revenue Code of 1954 to the extent provided in this paragraph (d).

The 1997 amendment to Section 6221 and 6226(f) restricted the jurisdictional transfer to the applicability of penalties to adjustments to partnership items and left all else within the realm of the partner-level deficiency proceeding.

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[12] Temp. Reg. § 301.6231(a)(5)-1T(d)(1) speaks in terms of "additions to tax" which include penalties such as the Section 6661 predecessor to Section 6662.

Petaluma II and *III* and *Jade II IV* confirm that penalties applicable to affected item adjustments still must be determined at the partner level. Yet, the IRS effectively denies the existence of that viable category via four errors.

One, the IRS proceeds as if all penalties on affected items fall within partnership jurisdiction because affected items are affected by partnership items. IRS Br. 33-4. However, the IRS then attempts to extract some retained affected item penalty vitality by resorting to pure nonpartnership items that have nothing to do with the partnership. Those items are not subject to any aspect of the TEFRA procedures – including the affected item proceeding.

Two, the IRS repeatedly resorts to the payment red herring (that partners, not partnerships, pay taxes) as a means of avoiding the critical distinction recognized by *Petaluma II* and *Jade II* as to the ability to compute the penalty. That is, the IRS masks the practical jurisdictional differences between (i) the *ability* to compute the underpayment and any applicable underpayment penalty flowing from disallowed partnership losses and (ii) the jurisdictional *inability* to compute the underpayment and any applicable underpayment penalty from the former partner's post-partnership losses. IRS Br. at 27. Where, as here, the penalty/reasonable cause determination is ultimately based on the contents of the partner's return (outside basis and resulting losses), the targeted activity constitutes partner activity, not the partnership conduct targeted by the 1997 amendment.

Three, ignoring the computation ability/inability distinction defies the Section 6230(a)(2) partner-level deficiency proceeding. By definition, deficiency proceedings precede assessment. 26 U.S.C. § 6211. If the IRS succeeds in pre-empting the partner-level jurisdiction by computing and assessing the affected-item underpayment and penalty at the "computational adjustment" stage, that will eliminate the deficiency and thus the deficiency proceeding in virtually every instance involving penalties on affected item which require partner-level deficiency proceedings.

Four, the IRS focuses almost exclusively upon the two word transitional reference "relates to" with little regard to the operative "applicability of any penalty" and "adjustment" or the statutory scheme. IRS Br. at 27-34. In that context, an accuracy-related underpayment penalty that remains inapplicable to a partnership item (based on most of the conjunctive elements of the penalty) does NOT "relate to" an "adjustment partnership item" – an item that, at most, constitutes an "element" of outside basis that requires a partner-level proceeding for the affected-partners. *Petaluma II*, 591 F.3d at 655-56; *Jade II*, 598 F.3d at 1380.

Congress could not have possibly intended the result the IRS seeks: empower the IRS at the "computational adjustment" stage to pre-empt the determination of the deficiency (and any penalties applicable to affected-items which require a deficiency proceeding) in the Section 6230(a)(2) partner-level jurisdictional proceeding.

5. The IRS Relies Most Heavily Upon the Untested *Tigers Eye II* Thin Plurality Opinion and its Jurisdictional Contradictions.

The IRS relies most heavily upon the thin plurality opinion in *Tigers Eye II* (6-3-6), the only partnership opinion that supports the IRS position (which we believe was on the verge of being reversed when this Court accepted *Woods* for review). The *Tigers Eye II* plurality actually demonstrates the internal contradictions urged by the IRS here:

(i) The *Tigers Eye II* plurality bottomed its imposition of penalties on the outside basis at the partnership level on its conclusion that outside basis constitutes a partnership item (138 T.C. at 69-70) – which the IRS D.C. Circuit brief in *Tigers Eye III* concedes is flat wrong.

(ii) A comparison of *Tigers Eye I* and *II* embodies the jurisdictional conflict: on jurisdictional grounds, *Tigers Eye I* bars the partners from asserting their Section 6664(c) reasonable cause/reliance defense of their outside basis. The *Tigers Eye II* plurality opinion not only imposes the "Valuation Misstatement" penalty on that same outside basis – it purports to reject the merits of the partners' reasonable cause/ reliance defense the Court previously barred.

(iii) The dissent by Judge Holmes artfully summarizes the problems in the plurality opinion, including defiance of circuit precedent.

As a final practical matter, a procedural rule that requires a 126-page explanation cannot be right.

C. PENALTY JURISDICTION CANNOT SIMULTANEOUSLY PUNISH PARTNERS BASED ON THE CONTENTS OF THEIR RETURNS AND BAR THEIR DEFENSE.

Every civilized society since the ancient Greeks has recognized that penalties must be narrowly construed, because a man or woman cannot be punished for an act or word the law failed to clearly prohibit. Through Lycurgus, the early Spartans extended the principle a step further by prohibiting any written law, on the belief that no man or woman could be punished for failing to abide by a law too complex to be remembered.

For both reasons, tax penalty provisions should be narrowly construed.[13] *Ivan Allen Co. v. United States,* 422 U.S. 617, 641 (1975) ("[T]he tax is, as the Court concedes, a penalty and therefore must be strictly construed ...") (internal quotations omitted); *Commissioner v. Acker,* 361 U.S. 87, 91 (1959) ("We are here concerned with a taxing Act which imposes

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[13] Perhaps Judge Campbell of the Seventh Circuit Court of Appeals put it best: "[T]here is an additional consideration which reinforces, and to my mind solidifies, this analysis: *odioso restinjenda sunt* (translation: things odious must be strictly construed). This ancient principle of common law is so venerated that it is even applied to the tax gatherer ..." *Brockhouse v. United States,* 749 F.2d 1248, 1255 (7th Cir. 1984) (Campbell, J., dissenting). Judge Campbell goes on to cite *Federal Communications Commission v. American Broadcasting Co.,* 347 U.S. 284, 296 (1954), for the principle that penal statutes must be construed strictly and *Commissioner v. Acker,* 361 U.S. 87, 91 (1959), for the principle that a tax penalty applies only if the words of the statute plainly impose it.

a penalty. The law is settled that 'penal statutes are to be construed strictly.'"), *quoting Federal Communications Commission v. American Broadcasting Co.*, 347 U.S. 284, 296 (1954); *Bradley v. United States*, 817 F.2d 1400, 1403 (9th Cir. 1987) ("A tax provision which imposes a penalty is to be construed strictly"); *Central Motor Co. v. United States*, 583 F.2d 470, 481 (10th Cir. 1978) ("And we must remember we are dealing with a tax penalty statute which is to be strictly construed"); *Howell v. Commissioner*, 77 T.C. 916, 933 (1981) (Fay, J., concurring), *citing Acker*, 361 U.S. at 91. More to the point, the partnership penalty jurisdictional statute cannot be stretched beyond its limits ("court," "adjustment," "partnership item") to seize the territory Congress preserved for partner-level deficiency jurisdiction.

The penalty advantage the IRS seeks turns this fundamental principle on its head. Consider the cumulative effect of what the IRS advocates:

(i) The IRS seeks to impose heightened penalties on the former partners at the partnership level based on the contents of their individual returns;

(ii) At the partnership level, the IRS specifically seeks to impose what it calls the "basis overstatement penalty" on the "outside basis" that the partnership never reports, the former partners alone report on their individual returns, and that the IRS (along with four Courts of Appeal) admits constitutes an affected-item that requires a partner-level deficiency proceeding under Section 6230(a)(2);

(iii) The IRS seeks to impose the penalty on those partner-level items while barring those partners from defending themselves; and

(iv) For the first time in any of these cases, the IRS now insists that the IRS not only imposes those penalties on those partner-items of those partners while they are gagged by Temp. Reg. §§ 301.6221-1T(c), (d), and *Tigers Eye I* – the IRS insists the penalty determination is "conclusive" and "unreviewable." IRS Br. 23, 35.

That "flog-'em-now/try-em-later" tactic certainly serves the efficient-justice concept the IRS advocates as its sole policy argument. For that matter, it would be so much more efficient if we just did away with defenses and trials altogether. The IRS suggests no other policy considerations apply. IRS Br. 37.

The right to a fair trial prior to the imposition of a penalty, the right to defend one's self before being punished and prejudiced in the later partner-level litigation with a "conclusive" penalty finding, and the purpose reflected by the interplay between Sections 6226(f) and 6230(a) of dealing with the partnership return at the partnership level and the partner return at the partner level – all constitute self-evident, worthwhile, policy considerations, with Fifth (substantive due process), Sixth (right to fair trial), and Eighth (excessive fines and penalties) Amendment overtones.

Better than anyone, the IRS knows that barred defenses will be the permanent result for many people because the IRS couples its pre-defense demand for payment of all outside-basis driven taxes, interest, and 40 percent penalty with another draconian device – a six month accelerated payment limitations period many will not be able to meet.

Three aspects set that heavy-handed approach in context. First, the tactic violates the spirit and the letter of Section 6664(c). Section 6664(c) bars the imposition of penalties on underpayments in the face of good faith reasonable cause. Congress enacted that protection in 1989 – after adopting TEFRA in 1982 – to ensure "a *standardized exception criterion* for all ... accuracy-related penalties." H.R. Rep. No. 101-247, at 1392-3 (1989), reprinted in U.S.C.C.A.N. 1906, 2862-3. No doubt exists as to why: "The committee is concerned that the present-law accuracy-related penalties (particularly the penalty for substantial understatement of tax liability) have been determined too routinely and automatically by the IRS." *Id.* Every aspect of that statute and its legislative history opposes the litigation tactic the IRS seeks to apply here – imposing underpayment penalties at the partnership level on select partners with respect to the partner-specific options, basis, and losses they reported on their individual returns BEFORE they can defend themselves. Second, that tactic offends the traditional tax prepayment safeguard – the long-held right of taxpayers to litigate IRS income tax deficiencies without having to pay before the correct amount is determined. *See, e.g.*, 26 U.S.C. §§ 6201(a), 6211, 6213(a), and their predecessors.

The IRS argues the exact opposite point here that it urged upon the Ninth Circuit in defense of the notice of deficiency it issued in *Napoliello*:

> By issuing a notice of deficiency, the IRS permits a partner to dispute the amount owed before paying the tax. If the IRS assesses taxes through a direct computational adjustment, a partner's only recourse is to pay the tax and to file a refund suit. *Napoliello,* 655 F.3d at 1064 (citations omitted).

There, the Ninth Circuit recognized the right to a pre-payment forum as a "procedural safeguard." With the exception of only those penalties that "relate to *adjustments to partnership* items," Section 6230(a)(2) guarantees that important safeguard to all partners with unresolved affected items that require a partner-level proceeding – *a la Woods*.

Third, another important safeguard arises from the historic right of a taxpayer to pay the disputed income tax deficiency, file a claim for refund (within the later of three years from the due date of the return or two years from payment), and, if denied, sue on that claim for refund (within two years of the denial). Contrast those safeguards with the dictate that the taxpayer pay any penalty assessed within six months of receipt of a "computational adjustment" notice OR BE FOREVER BARRED.

CONCLUSION

On behalf of the partners in *Petaluma*, *Jade*, and *Tigers Eye*, we urge this Court to adopt the three-prong reconciliation set forth in our Summary of Argument, bar the premature imposition of penalties that require partner-level deficiency proceedings, and reverse the imposition of Section 6662 penalties that cannot be computed without outside basis.

Respectfully submitted,

DAVID D. AUGHTRY
Counsel of Record
Chamberlain, Hrdlicka, White
Williams & Aughtry
191 Peachtree Street N.E.
34th Floor
Atlanta, Georgia 30303
(404) 659-1410
David.Aughtry@chamberlainlaw.com

EDWARD M. ROBBINS, JR.
Hochman, Salkin, Rettig,
Toscher & Perez, P.C.
9150 Wilshire Boulevard
Suite 300
Beverly Hills, California 90212-3414
(310) 281-3247
EdR@taxlitigator.com

ATTORNEYS FOR *AMICI CURIAE*

JULY 26, 2013

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APPENDIX OF PERTINENT STATUTORY AND REGLULATORY AUTHORITY

Internal Revenue Code of 1986 (26 U.S.C.)
(as amended through December 27, 1999)

§ 722 BASIS OF CONTRIBUTING PARTNER'S INTEREST.

The basis of an interest in a partnership acquired by a contribution of property, including money, to the partnership shall be the amount of such money and the adjusted basis of such property to the contributing partner at the time of the contribution increased by the amount (if any) of gain recognized under section 721(b) to the contributing partner at such time.

§ 732 BASIS OF DISTRIBUTED PROPERTY OTHER THAN MONEY.

(a) DISTRIBUTIONS OTHER THAN IN LIQUIDATION OF A PARTNER'S INTEREST.—

(1) GENERAL RULE.—The basis of property (other than money) distributed by a partnership to a partner other than in liquidation of the partner's interest shall, except as provided in paragraph (2), be its adjusted basis to the partnership immediately before such distribution.

(2) LIMITATION.—The basis to the distributee partner of property to which paragraph (1) is applicable shall not exceed the adjusted basis of such partner's interest in the partnership reduced by any money distributed in the same transaction.

(b) DISTRIBUTIONS IN LIQUIDATION.—The basis of property (other than money) distributed by a partnership to a partner in liquidation of the partner's interest shall be an amount equal to the adjusted basis of such partner's interest in the partnership reduced by any money distributed in the same transaction.

§ 752 TREATMENT OF CERTAIN LIABILITIES.

* * *

(b) DECREASE IN PARTNER'S LIABILITIES.—Any decrease in a partner's share of the liabilities of a partnership, or any decrease in a partner's individual liabilities by reason of the assumption by the partnership of such individual liabilities, shall be considered as a distribution of money to the partner by the partnership.

§ 1012 BASIS OF PROPERTY—COST.

The basis of property shall be the cost of such property, except as otherwise provided in this subchapter and subchapters C (relating to corporate distributions and adjustments), K (relating to partners and partnerships), and P (relating to capital gains and losses). The cost of real property shall not

include any amount in respect of real property taxes which are treated under section 164(d) as imposed on the taxpayer.

§ 6226 JUDICIAL REVIEW OF FINAL PARTNERSHIP ADMINISTRATIVE ADJUSTMENTS.

* * *

(f) SCOPE OF JUDICIAL REVIEW.—A court with which a petition is filed in accordance with this section shall have jurisdiction to determine all partnership items of the partnership for the partnership taxable year to which the notice of final partnership administrative adjustment relates, the proper allocation of such items among the partners, and the applicability of any penalty, addition to tax, or additional amount which relates to an adjustment to a partnership item.

§ 6230 ADDITIONAL ADMINISTRATIVE PROVISIONS.

(a) COORDINATION WITH DEFICIENCY PROCEEDINGS.—

(1) IN GENERAL.—Except as provided in paragraph (2) or (3), subchapter B of this chapter shall not apply to the assessment or collection of any computational adjustment.

(2) DEFICIENCY PROCEEDINGS TO APPLY IN CERTAIN CASES.—

(A) Subchapter B shall apply to any deficiency attributable to—

(i) affected items which require partner level determinations (other than penalties, additions to tax, and additional amounts that relate to adjustments to partnership items), or
(ii) items which have become nonpartnership items (other than by reason of section 6231(b)(1)(C)) and are described in section 6231(e)(1)(B).

(B) Subchapter B shall be applied separately with respect to each deficiency described in subparagraph (A) attributable to each partnership.

§ 6231 DEFINITIONS AND SPECIAL RULES.

(a) DEFINITIONS.—For purposes of this subchapter—

* * *

(3) PARTNERSHIP ITEM.—The term "partnership item" means, with respect to a partnership, any item required to be taken into account for the partnership's taxable year under any provision of subtitle A to the extent regulations prescribed by the Secretary provide that, for purposes of this subtitle, such item is more appropriately determined at the partnership level than at the partner level.

* * *

(5) AFFECTED ITEM.—The term "affected item" means any item to the extent such item is affected by a partnership item.

§ 6662. IMPOSITION OF ACCURACY-RELATED PENALTY ON UNDERPAYMENTS.

(a) IMPOSITION OF PENALTY.—If this section applies to any portion of an underpayment of tax required to be shown on a return, there shall be added to the tax an amount equal to 20 percent of the portion of the underpayment to which this section applies.

(b) PORTION OF UNDERPAYMENT TO WHICH SECTION APPLIES.—This section shall apply to the portion of any underpayment which is attributable to 1 or more of the following:

(1) Negligence or disregard of rules or regulations.

(2) Any substantial understatement of income tax.

(3) Any substantial valuation misstatement under chapter 1.

(4) Any substantial overstatement of pension liabilities.

(5) Any substantial estate or gift tax valuation understatement.

This section shall not apply to any portion of an underpayment on which a penalty is imposed under section 6663.

§ 6664 DEFINITIONS AND SPECIAL RULES.

* * *

(c) REASONABLE CAUSE EXCEPTION.—

(1) IN GENERAL.—No penalty shall be imposed under this part with respect to any portion of an underpayment if it is shown that there was a reasonable cause for such portion and that the taxpayer acted in good faith with respect to such portion.

§ 7491 BURDEN OF PROOF.

* * *

(c) PENALTIES.—Notwithstanding any other provision of this title, the Secretary shall have the burden of production in any court proceeding with respect to the liability of any individual for any penalty, addition to tax, or additional amount imposed by this title.

Treasury Regulations (26 C.F.R.)
(as amended through December 27, 1999)

§ 301.6221-1T. Tax treatment determined at partnership level (Temporary).

* * *

(c) *Penalties determined at partnership level (partnership taxable years ending after August 5, 1997).* Any penalty, addition to tax, or additional amount that relates to an adjustment to a partnership item, shall be determined at the partnership level. Partner level defenses to such items can only be asserted through refund actions following assessment and payment. Assessment of any penalty, addition to tax, or additional amount that relates to an adjustment to a partnership item shall be made based on partnership level determinations. Partnership level determinations include all the legal and factual determinations that underlie the determination of any penalty, addition to tax, or additional amount, other than partner level defenses specified in paragraph (d) of this section.

(d) *Partner level defenses.* Partner level defenses to any penalty, addition to tax, or additional amount that relates to an adjustment to a partnership item, may not be asserted in the partnership level proceeding, but may be asserted through separate refund actions following assessment and payment. See section 6230(c)(4). Partner level defenses are limited to those that are personal to the partner or are dependant upon the partner's separate return, and cannot be determined at the partnership level.

Examples of these determinations are: whether any applicable threshold underpayment of tax has been met with respect to the partner or whether the partner has met the criteria of section 6664(b) (penalties applicable only where return is filed), or section 6664(c)(1) (reasonable cause exception) subject to partnership level determinations as to the applicability of section 6664(c)(2).

§ 301.6231(a)(5)-1T. **Definition of affected item (Temporary).**

* * *

(b) *Partner's basis in his partnership interest.* A partner's basis in his interest in the partnership is an affected item to the extent it is not a partnership item.

* * *

(d) *Addition to tax or additional amounts*—(1) *In general.* The term "affected item" includes addition to tax or additional amount provided in subchapter A of chapter 68 of the Internal Revenue Code of 1954 to the extent provided in paragraph (d).

§ 301.6231(a)(6)-1T. **Computational adjustments (Temporary).**

(a) *In general.* * * *

(1) Changes in a partner's tax liability with respect to affected items that do not require partner level determinations (such as the threshold amount of medical deductions under section 213 that changes as the result of determinations made at the partnership level) are computational adjustments that are directly assessed. When making computational adjustments, the Service may assume that amounts the partner reported on the partner's individual return include all amounts reported to the partner by the partnership, absent contrary notice to the Service (for example, a "Notice of Inconsistent Treatment"). Such an assumption by the Service does not constitute a partner level determination. Moreover, substituting redetermined partnership items for the partner's previously reported partnership items (including partnership items included in carryover amounts) does not constitute a partner level determination where the Service otherwise accepts all nonpartnership items (including, for example, nonpartnership item components of carryover amounts) as reported.

(2) Changes in a partner's tax liability with respect to affected items that require partner level determinations (such as a partner's at-risk amount to the extent it depends upon the source from which the partner obtained the funds that the partner contributed to the partnership) are computational adjustments subject to deficiency procedures. Nevertheless, any penalty, addition to tax, or

additional amount that relates to an adjustment to a partnership item may be directly assessed following a partnership proceeding, based on determinations in that proceeding, regardless of whether partner level determinations are required.

AMICUS CURIAE BRIEF

RECORD AND BRIEFS

No. 12-562

Supreme Court, U.S.
FILED
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In The

Supreme Court of the United States

UNITED STATES OF AMERICA,

Petitioner,

v.

GARY WOODS, AS TAX MATTERS PARTNER OF TESORO DRIVE PARTNERS, ET AL.,

Respondents.

On Writ Of Certiorari To The United States Court Of Appeals For The Fifth Circuit

BRIEF OF *AMICUS CURIAE* PROFESSOR DAVID J. SHAKOW IN SUPPORT OF RESPONDENTS

DAVID J. SHAKOW
Amicus Curiae and Counsel of Record
PROFESSOR OF LAW, EMERITUS
UNIVERSITY OF PENNSYLVANIA LAW SCHOOL
3501 Sansom Street
Philadelphia, PA 19104
dshakow@law.upenn.edu
(215) 898-7483

COCKLE LEGAL BRIEFS (800) 225-6964
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INTEREST OF *AMICUS CURIAE*

Amicus is a teacher and scholar of the tax law. The issues in this case involve a subject in which he has a special interest and about which he has been engaged for some time in writing. Except for that academic interest, he has no interest in the outcome of this case.[1]

As can be seen from the "Summary of Argument," *Amicus* takes a view of the issues involved in this case and their proper resolution that is wholly different from that taken by the courts below. The issues are important, and in resolving them the Court

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[1] The parties have consented to the filing of this brief. Pursuant to Rule 37.3(a), letters consenting to the filing of this brief are on file with the Clerk of the Court. No counsel for a party authored this brief in whole or in part, and no counsel or party made a monetary contribution intended to fund the preparation or submission of this brief. No person other than *amicus curiae* made a monetary contribution to its preparation or submission. Besides being Professor of Law, Emeritus, at the University of Pennsylvania Law School, *Amicus* is also counsel at Chamberlain, Hrdlicka, White, Williams & Aughtry. Chamberlain Hrdlicka is filing an *amicus* brief in this case on behalf of a number of clients. The brief *Amicus* is filing reflects the findings of an article that *Amicus* submitted for publication prior to the granting of *certiorari* in this case. *See* David J. Shakow, *Valuation Misstatement Penalties Require Valuation Misstatements*, 139 TAX NOTES 1283 (6/10/2013), *available at* http://ssrn.com/abstract=2281915 (with appendices). The time spent preparing the article, and the additional time spent on this *amicus* brief, will not be charged to any client.

should have the benefit of a presentation of all the competing views.

INTRODUCTION AND SUMMARY OF ARGUMENT

In 1999, taxpayer participated in a tax shelter called Current Options Bring Reward Alternatives ("COBRA"). In simplified form, taxpayer purchased and sold offsetting short-term options on a foreign currency, and contributed the options, plus a relatively small amount of cash, to a partnership. The taxpayer claimed that it had a basis in the partnership equal to its basis in the "long" option, with no reduction for the obligation inherent in the "short" option. The partnership purchased an asset with a portion of the cash and then liquidated, distributing the asset to the taxpayer. Under a mechanical application of the partnership rules, this resulted in a high basis in the distributed property, which was then sold for a substantial loss.

As it has been framed by the courts below, the question is how to apply the valuation misstatement penalties, 26 U.S.C. § 6662(e) and (h), when the taxpayer had no business purpose for entering into the transaction.[2] The Government contends that the penalties can be applied in this context.

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[2] The Court has also directed the parties to consider the jurisdiction of the district court under 26 U.S.C. § 6226 to

(Continued on following page)

In so addressing the issue, the government, like the court below, presumes that the transaction at issue may be subject to "valuation misstatement" penalties although no issue was raised relating to any valuation asserted by the taxpayer in structuring the transaction. My examination of the sections at issue reveals that these "valuation misstatement" penalties are properly applied only if the taxpayer has made a valuation misstatement. Since the taxpayer has not done so, those penalties cannot in any event apply.

It follows that the Court should sustain the decision below on the basis that the penalty cannot apply in this situation in any event.

ARGUMENT

I. THE CODE REQUIRES A VALUATION MISSTATEMENT IF A VALUATION MISSTATEMENT PENALTY IS IMPOSED

Section 6662(e)(1)(A) of the Internal Revenue Code states:

> (e) Substantial Valuation Misstatement Under Chapter 1. –
>
> > (1) In General. – For purposes of this section, there is a substantial valuation misstatement under chapter 1 if –

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consider the substantial valuation misstatement penalty. *Amicus* takes no position on that issue.

> (A) the value of any property (or the adjusted basis of any property) claimed on any return of tax imposed by chapter 1 is 150 percent or more of the amount determined to be the correct amount of such valuation or adjusted basis (as the case may be). . . .

Section 6662(a) applies a 20% penalty if there is a "substantial valuation misstatement." Under section 6662(h), the penalty is increased to 40% when the value (or adjusted basis) is 200% or more of the correct amount, because there is then a "gross valuation misstatement."

The question considered by the courts below was whether the valuation misstatement penalty in section 6662(h) applies to the taxpayers. If it does, it applies because the basis used by the taxpayers in calculating the tax on their tax return was more than 200% of the amount determined to be the correct basis. That reflects an understanding that "basis" in section 6662(e)(1)(A) refers to basis determined by a taxpayer in any manner.

Amicus submits that there are three possible ways of understanding the reference to basis in the definition of a valuation misstatement in section 6662(h).

- It could refer to basis used by a taxpayer on a tax return in all circumstances.

- It could refer to basis used by a taxpayer either when the basis is a function of a valuation

misstatement or when the taxpayer is engaged in an abusive tax shelter.

- It could refer to basis used by a taxpayer when the basis is a function of a valuation misstatement.

Amicus will demonstrate below that the first approach, advanced by the Government in its brief,[3] extends the reach of the penalty to many and varied situations under the Internal Revenue Code. Although it purports to rely on the plain meaning of the statute, it does so by ignoring the context in which the provision appears. Moreover, during the thirty-two years since this provision was added to the Code, the Commissioner has ignored this "plain meaning" over and over. The Commissioner has failed to apply the penalty in many situations where the facts warranted

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[3] In its discussion of the "plain text" of the valuation misstatement penalty, the Government's brief states:

> Indeed, in many contexts other than transactions that lack economic substance, a basis overstatement is produced by a misapplication of basis-computation rules rather than by a simple factual error. For example, a corporation may overstate its basis in a subsidiary due to a misapplication of regulations relating to consolidated returns. *See* 26 C.F.R. § 1.1502-32. If the corporation were to determine its gain or loss on the sale of the subsidiary using the overstated basis, resulting in an understatement of the corporation's overall taxable income and ultimately in an underpayment of tax, the overstatement penalty would surely apply.

U.S. Br. 42.

application of the penalty, as so understood, and other penalties were imposed on taxpayers. The common thread in these cases, where the Commissioner failed to act, is that the taxpayer's inflated basis did not flow from valuation misstatements.

The second approach appears to be the IRS's current application of the valuation misstatement penalty. There is no justification for extending the penalty to tax shelter transactions that do not involve valuation misstatements. Congress has included specific provisions in the Code to deal with abusive tax shelters generally, but the valuation misstatement penalties in section 6662 have not been so extended.

The third approach is most consistent with the language of the statute in context and its legislative history, reflects the application of the penalty throughout most of its history, and avoids an extension of the penalty to a wide variety of cases to which it has never been applied. *Amicus*'s review of the case law demonstrates that the Commissioner has generally concluded that a valuation misstatement penalty requires a valuation misstatement. The penalty should be so limited.

II. THE LANGUAGE OF THE PENALTY AND ITS LEGISLATIVE BACKGROUND CONFIRM THAT A VALUATION MISSTATEMENT IS REQUIRED

Section 6659 of the Internal Revenue Code, the original valuation misstatement provision, was titled "Addition to Tax in the Case of Valuation Overstatements for Purposes of the Income Tax." It was added to the Internal Revenue Code in 1981. Section 6659(c) read:

> VALUATION OVERSTATEMENT DEFINED – For purposes of this section, there is a valuation overstatement if the value of any property, or the adjusted basis of any property, claimed on any return is 150 percent or more of the amount determined to be the correct amount of such valuation or adjusted basis (as the case may be).

Section 1012(a) defines "basis" of property as "the cost of such property, except as otherwise provided in this subchapter and subchapters C . . . , K . . . , and P. . . ." Section 1011(a) defines "adjusted basis" as "the basis (determined under section 1012 . . .), adjusted as provided in section 1016." Since these definitions appear to have nothing to do with value, the reader could be confused by the reference to "basis" in the definition of a valuation overstatement. The explanation is that valuation overstatements do not affect tax liabilities only directly, as for example, when a taxpayer claims a deduction for the charitable contribution of an artwork based on an overvaluation.

In many tax-motivated transactions, taxpayers "pay" a substantially inflated price for an item, using mostly non-recourse debt, in order to get the immediate tax benefits of the resulting very high basis. The valuation is not reflected directly on the tax return, but the high basis in the purchased asset results from the inflated valuation. At the time section 6659 was added to the Code, there were "about 500,000 tax disputes outstanding which involve property valuation questions of more than routine significance." H.R. Rep. No. 97-201, 97th Cong., 1st Sess. 243 (July 24, 1981). Based on the decided cases (discussed below), the overwhelming majority involved bases inflated through overvaluation.

For example, in *Provizer v Commissioner*, 65 T.C.M. (CCH) 2531 (1992), *aff'd per curiam without published opinion*, 996 F.2d 1216 (6th Cir. 1993), *cert. denied*, 510 U.S. 1163 (1994), a test case for approximately 1850 docketed and undocketed cases involving a plastics recycling tax shelter, the court said:

> "Here, assets with approximate fair market values of $50,000 were valued by petitioners at $1,162,666 each. Petitioners' valuations are by definition overstated within the meaning of section 6659."

The valuations were relevant because taxpayers had calculated depreciation and tax credits based on the price they paid for the equipment. If "valuation overstatements" were limited to situations where the overstated *value* appeared directly on the return, the penalty might not apply in cases such as *Provizer*.

Therefore, a reference to basis was included by Congress in the definition of a "valuation" overstatement.

III. THERE IS ONLY ONE REASONABLE WAY TO UNDERSTAND SECTION 6659, THE PREDECESSOR OF THE CURRENT PENALTY PROVISION

Although the statute, as originally passed, did not state explicitly that inflated basis must result from a misvaluation, it is hard to interpret it otherwise. The section's title and the operative definition in section 6659(c), quoted above, refer to a *valuation* overstatement. Most recently in 2008, the Court confirmed that statutory titles and section headings "are tools available for the resolution of a doubt about the meaning of a statute." *Florida Dept. of Revenue v. Piccadilly Cafeterias, Inc.*, 554 U.S. 33, 47 (2008), *quoting Porter v. Nussle*, 534 U.S. 516, 528 (2002). Use of a title to interpret a statute is particularly apt where the title is reinforced by legislative history. *Almendarez-Torres v. United States*, 523 U.S. 224, 234 (1998).

It is clear from the legislative history of this penalty that Congress's target was serious overvaluations of assets and their effect on the courts. The "Reasons for Change" included in the House Committee's report when section 6659 was added to the Internal Revenue Code in 1981 contains the following explanation:

> The Committee believes that a specific penalty was needed to deal with various problems related to valuation of property. This particular need is illustrated by the fact that there are about 500,000 tax disputes outstanding which involve property valuation questions of more than routine significance. These cases alone involve approximately $2.5 billion in tax attributable to the valuation issues.
>
> The committee recognizes that valuation issues frequently involve difficult questions of fact. Often these issues seem to be resolved simply by "dividing the difference" in the values asserted by the Internal Revenue Service and those claimed by the taxpayer. Because of this approach to valuation questions, the committee believes that taxpayers were encouraged to overvalue certain types of property and to delay the resolution of valuation issues. . . .
>
> In recognition of the fact that valuation issues often are difficult, especially where unique property is concerned, the committee decided to adopt a "bright line" test for the application of a new penalty. Under this test, only significant overvaluations will be penalized. . . .

H.R. Rep. No. 97-201, 97th Cong., 1st Sess. 243 (July 24, 1981). The House bill was adopted in Conference. H.R. Rep. No. 97-215, 97th Cong., 1st Sess. 262-263 (August 1, 1981). There is no substantive discussion of the reasons for the valuation misstatement

penalties in the legislative history of the 1989 revision of these provisions, which moved the penalty into section 6662. This change is discussed below.

The extension of this penalty by the Commissioner to all transactions that lack economic substance, as detailed in Part VI, below, is inconsistent with Congress's understanding of the provision. The language of the provision, its history and its application demonstrate that it was intended to deal with valuation misstatements.

IV. SECTION 6659 WAS APPLIED CONSISTENT WITH ITS LANGUAGE AND STATED PURPOSE

The valuation misstatement penalty of section 6659 was applied consistently to cases where there was a valuation misstatement. *Amicus* reviewed the cases (close to 1,000) which cite section 6659. *Amicus* examined the facts of the cases, around 450, that clearly involved substantive attempts by the IRS to exact the valuation misstatement penalty from taxpayers.[4] Issues of valuation were present in virtually

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[4] *See* cases listed in Appendix B of David J. Shakow, *Valuation Misstatement Penalties Require Valuation Misstatements*, 139 TAX NOTES 1283 (6/10/2013), *supra* note 1. *Amicus* used RIA Checkpoint to identify all the cases that cited section 6659 and attempted to categorize each one. There were many in which section 6659 was cited but not applied, and many in which the facts underlying the transaction were not spelled out with enough detail to allow *Amicus* to determine why the penalty had been asserted. In some cases, the IRS did not assert the penalty

(Continued on following page)

all of the cases in which the section 6659 penalty was asserted.[5] Sixty-three involved overstated charitable contributions. It is straightforward to apply an overvaluation penalty in such a case, because the taxpayer's underpayment flows directly from the overvaluation. One involved claimed improvements on a farm purchased by a limited partnership, a

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for valuation misstatements under section 6659, but instead imposed the higher interest rate on deficiencies mandated by section 6621(c) when a transaction involves a valuation misstatement as defined in section 6659. It is not clear why the section 6659 penalty itself was not asserted in those cases, although in some it is possible that the penalty under section 6659 would not have led to an additional payment by the taxpayer because of other penalties to which the taxpayer was subject. Section 6621(c) was repealed in the 1989 Act, which redefined the scope of the valuation misstatement penalty and moved it from section 6659 to section 6662.

[5] One possible exception is *Groves v. Commissioner*, 78 T.C.M. (CCH) 1201 (1999). Although the facts are not set out clearly in the opinion, it appears the taxpayer recorded basis of stock he sold without a factual foundation for the numbers used. In *Massengill v. Commissioner*, 56 T.C.M. (CCH) 107 (1988), *aff'd*, 876 F.3d 616 (8th Cir. 1989), the Commissioner argued that the taxpayer had engaged in a transaction without economic substance, and hence had a zero basis in the asset in question. The court applied section 6659 without a clear finding related to valuation. In other cases that applied section 6659 in response to an argument that the taxpayer had zero basis, the courts' findings reflect the overvaluation of the assets in question, and courts often relied on that finding in applying the penalty. *See, e.g., Gilman v. Commissioner*, 93 F.3d 143, 150 (2d Cir. 1991).

transaction which the court does not clearly label as a tax shelter.[6]

The other 380 or so were tax shelters, almost all of which were based on overvaluations of property. In many cases, the overvaluation led directly to an inflated purchase price and an inflated basis, as in *Provizer*, discussed above. Many of these cases, like *Provizer*, involved more than one taxpayer.

As the Government concedes in its brief, its argument is that the "overvaluation" penalty applies whenever a taxpayer has basis in excess of fair market value, and this can happen when there is no overvaluation. U.S. Br. 41-42. The Government does not acknowledge that there are many situations where this would be so; that these situations are not just theoretical, but they have arisen in reported cases; that those cases involved other penalties that the Commissioner asserted, so there is no question that the taxpayer's actions were subject to sanction; but that the Commissioner has not asserted the overvaluation penalty in those circumstances. It strains credulity to maintain that the Commissioner has missed the alleged plain meaning of the statute for over thirty years. It seems similarly unlikely that Congress intended to impose a penalty with such an

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[6] *Weis v. Commissioner*, 94 TC 473 (1990) (limited partnership bought farm; claimed improvements had value 243% of actual value).

expansive scope under the rubric of an "over-valuation" penalty.

Below, *Amicus* identifies some of the circumstances where a taxpayer could claim a basis substantially in excess of actual basis, but valuation is not an issue. The cases cited in the footnotes were decided when the valuation misstatement penalty was in effect, and where asserting that penalty would have resulted in an additional penalty imposed on the taxpayer. The valuation misstatement penalty can be avoided if the taxpayer has "reasonable cause." 26 U.S.C. § 6659(e) ("authority to waive"); § 6664(c) (applies to all penalties under section 6662). However, where the Commissioner asserts another penalty that could be avoided if the taxpayer has "reasonable cause," it is clear the Commissioner could also have asserted the valuation misstatement penalty. In all cases, unless otherwise noted, the IRS did assert a different penalty.[7] Thus, these cases illustrate not only that an overbroad reading of the valuation misstatement penalty would result in it being applied in very many situations, but also that the IRS has limited the provision to situations where there is no valuation misstatement, except in some tax shelter cases such as the instant case:

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[7] Where *Amicus* found no case in which a penalty was asserted, *Amicus* included an illustrative case where the basis issue was present, although the Commissioner did not impose any penalties.

An item could be capitalized when it should not have been capitalized.[8]

A taxpayer may claim basis in property sold or depreciated but be unable to substantiate the basis.[9]

A taxpayer could fail to reduce basis by depreciation allowed or allowable.[10]

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[8] *Diaz v. Commissioner*, 104 T.C.M. (CCH) 213 (2012) (portion of overstated basis came from disallowing claimed capital expenditure); *Ashley v. Commissioner*, 80 T.C.M. (CCH) 841 (2000) (taxpayer apparently claimed basis of $356,000 on return; court allowed basis of $145,273.96, less depreciation allowed or allowable (amount not specified)); *Lewis v. Commissioner*, T.C. Summary Opinion 2001-142 (taxpayer calculated gain on property sold based on over $130,000 of capital expenditures, but only $46,000 allowed).

[9] *E.g.*, *Brodsky v. Commissioner*, T.C. Memo. 2001-240, 2001 WL 1078113 (IRS claimed zero basis for items taxpayer had assigned bases of $50,000 and $36,685); *Marcus v. Commissioner*, 71 T.C.M. (CCH) 2823 (1996) (IRS claimed zero basis for item sold for almost $38,000); *Hall v. Commissioner*, 65 T.C.M. (CCH) 2575 (1993) (IRS claimed zero basis for item sold for $33,000); *Riley v. Commissioner*, T.C. Summary Opinion 2007-26 (IRS claimed zero basis for items for which depreciation of $21,500 was taken); *Diaz v. Commissioner*, *supra* note 8 (claimed basis of $553,269 reduced by court to $154,000); *Allnutt v. Commissioner*, TC Memo 2004-239 (bases in various assets overstated by more than $500,000); *Leighton v. Commissioner*, 70 T.C.M. (CCH) 1109 (1995), *aff'd*, 108 F.3d 332 (5th Cir. 1997); *Tabbi v. Commissioner*, 70 T.C.M. (CCH) 836 (1995).

[10] *Lewis v. Commissioner*, T.C. Summary Opinion 2001-142 (taxpayer failed to reduce basis by $26,470 of depreciation allowed or allowable on property sold).

A taxpayer could use basis for loss, rather than basis for gain, for determining depreciation.[11]

A taxpayer could claim too high a basis in measuring a casualty loss.[12]

A liability associated with a property's purchase price could be improperly so associated.[13]

A stockholder could fail to reduce the basis of stock in respect of a return of capital distribution under section 301 or under section 1367.[14]

A homeowner could fail to make the correct basis adjustments in the case of a sale and purchase of a residence under section 1034.[15]

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[11] 26 U.S.C. § 167(c); *cf. Federal Home Loan Mortgage Corp. v. Commissioner*, 121 T.C. 129 (2003) (over $300 million difference in tax liability resulting from IRS claim that taxpayer should have used basis for gain rather than fair market value basis provided under special legislation; no penalty asserted).

[12] *See, e.g., Cziraki v. Commissioner*, 76 T.C.M. (CCH) 991 (1998).

[13] *See, e.g., Dunnegan v. Commissioner*, 71 T.C.M. (CCH) 2670 (1996), *aff'd on this issue*, 82 F.3d 404 (3d Cir. 1996) (liability improperly associated with purchase inflated basis of property that was repurchased under section 1034).

[14] *D'Errico v. Commissioner*, 103 T.C.M. (CCH) 1802 (2012) ($274,611 basis of S corporation stock reduced to zero under section 1367(a)(2) because of return-of-capital distributions).

[15] *See, e.g., Dunnegan v. Commissioner*, *supra* note 13. Section 1034 was repealed in 1997.

> A parent corporation could make a mistake adjusting its subsidiary's stock in the context of the complicated consolidated return regulations. *E.g.*, 26 C.F.R. § 1.1502-32.[16]

There are other Code sections whose misapplication could lead to overstated basis, but *Amicus* did not find decided cases where this occurred. These include:

> A taxpayer could overstate fair market value in making an election under section 83(b).
>
> A taxpayer could capitalize amounts allowed as research and development deductions under section 174.
>
> A taxpayer could capitalize development expenditures allowed as a deduction under section 616.
>
> A corporation could fail to make adjustments to the basis of stock of a controlled foreign corporation under section 961.
>
> A bondholder could fail to reduce a bond's basis for amortizable bond premium pursuant to section 1016(a)(5).
>
> A farmer could fail to adjust basis for a loan from the Commodity Credit Corporation,

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[16] *Cf. IU International Corp. v. United States*, 116 F.3d 1461 (Fed. Cir. 1997) (disagreement about application of the regulations affected about $10 million of gain; issue raised in refund suit, so no penalties involved).

pursuant to section 1016(a)(8), to the extent of loans treated as income under section 77.

Basis could be misallocated in the context of basis reduction under section 1017.

A taxpayer could fail to reduce basis by the amount of extraordinary dividends under section 1059.

The fact that *Amicus* could not locate cases illustrating these Code sections should not be taken to mean that such cases do not exist.

V. THE LANGUAGE OF THE CURRENT VERSION OF THE PENALTY CONFIRMS THAT IT APPLIES ONLY IF THERE IS A VALUATION MISSTATEMENT

As originally passed in section 6659, the penalty provision applied when "the value of any property, or the adjusted basis of any property" was inflated. As we have shown, the penalty was applied to cases involving actual overvaluations.

In 1989, the penalty provisions were restructured, and the overvaluation penalty was moved to section 6662. The legislative history of the valuation misstatement penalty, in both 1981 and 1989, is devoid of any discussion of inflated *basis*. The focus is on valuations.

The reenactment of the penalty in 1989 provides further support for the conclusion that it should be applied only when the taxpayer has overstated the

value of an asset. When the penalty was reenacted, the reference to basis overstatements was placed in a parenthetical: "the value of any property (or the adjusted basis of any property)." This affects how the statute should be understood. *See Chickasaw Nation v. United States*, 534 U.S. 84, 94-95 (2001). In interpreting a statute, the use of parentheticals indicates that the parenthetical phrase "*is related to, or dependent upon*" the non-parenthetical phrase it follows. *Disabled in Action of Pennsylvania v. Southeastern Pennsylvania Transportation Authority*, 539 F.3d 199, 212 (3d Cir. 2008) (emphasis added). "[P]arentheses 'reduce[ ] the grammatical import' of the language contained therein." *Id.*, *quoting Peters v. Ashcroft*, 383 F.3d 302, 309 (5th Cir. 2004).[17] In particular, courts may decline to ascribe independent meaning to a parenthetical statutory phrase (such as the one we are considering) beginning with the word "or" because "it can reasonably be construed to illustrate or explain"

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[17] *Peters*' full discussion of parentheses is as follows:

> [The court's] approach finds additional support in decisions, cited by this court in *Monjaras-Castaneda*, *supra* at 330, that have construed statutory parentheticals to signify clarifications, non-exclusive identifications, or visual aids. Congress in fact reduced the grammatical import of conspiracy and attempt, and correspondingly emphasized the breadth of "relating to," when it replaced commas cordoning off conspiracy in the predecessor provision with the parentheses that now appear.

383 F.2d at 308-309.

the preceding phrase. *Mizrahi v. Gonzales*, 492 F.3d 156, 166 (2d Cir. 2007).

It follows that the penalty for a 150% discrepancy in *adjusted basis* should be understood in light of the penalty for a 150% discrepancy in *value* that it follows. In other words, the basis overstatement to which section 6662(e) refers is one that arises from the type of problem that the section was targeted to address, namely subjective overvaluations that allow taxpayers to claim very large deductions or credits on their tax returns.

VI. THE VALUATION MISSTATEMENT PENALTY IS CURRENTLY APPLIED CONTRARY TO ITS LANGUAGE AND STATED PURPOSE

To evaluate where the IRS has, and has not, applied the penalty more recently, *Amicus* looked at the cases that have cited sections 6662(e) and 6662(h) (that is, the cases involving post-1989 tax years).[18] One hundred nineteen reported decisions cite section 6662(h), and another ten cite section 6662(e) without citing section 6662(h). This does not amount to 129

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[18] *See* Appendix A of David J. Shakow, *Valuation Misstatement Penalties Require Valuation Misstatements*, 139 TAX NOTES 1283 (6/10/2013), *supra* note 1. RIA Checkpoint identified 73 cases that refer to 6662(e) and 119 that refer to 6662(h). *Amicus* attempted to track down other cases where the reference was in a different form, such as "subsection (h) of section 6662," but surely did not find them all.

separate litigations, since the total includes a number of litigations that are reflected in more than one decided case.

An examination of the cases that cite section 6662(h) or section 6662(e) shows the following:

> Twenty-four cases involved the valuation of easements (such as conservation easements) and other assets contributed to tax-exempt entities;
>
> Two related to other valuation issues
>
> One applied the step transaction doctrine to disallow a step-up in the basis of stock[19]
>
> Twenty-five were "Son-of-BOSS" transactions[20]
>
> Seven were foreign currency shelters[21]
>
> Seven were cattle shelters promoted by Mr. Hoyt[22]

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[19] *G.D. Parker, Inc. v. Commissioner*, 104 T.C.M. (CCH) 627 (2012). This was not a marketed tax shelter.

[20] *E.g.*, *106 Ltd. v. Commissioner*, 684 F.3d 84 (D.C. Cir. 2012) (court concludes that basis of stock was inflated by disregarding a contingent liability).

[21] *E.g.*, *Klamath Strategic Investment Fund v. United States*, 568 F.3d 537 (5th Cir. 2009) (taxpayer reduces amount of liability related to investment in currency-trading partnership by having very high interest rate on loan).

[22] These were cattle breeding shelters. *E.g.*, *Keller v. Commissioner*, 556 F.3d 1056 (9th Cir. 2009) (cattle overvalued).

Four were CARDS shelters[23]

Twenty-one were other promoted shelter transactions.[24]

If we put aside the cases that directly raised an issue of valuation (26 charitable contribution and other valuation cases) and look only at the basis cases, we find that significantly less than half of them involve a basis inflated because of an overvaluation.[25]

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[23] *E.g.*, *Gustashaw v. Commissioner*, 110 A.F.T.R.2d 2012-6169 (11th Cir. 2012) (taxpayer uses full amount of loan as basis, although taxpayer is only responsible for repayment of principal).

[24] The total of cases identified in the text is smaller than the number of cases that cite 6662(e) or (h). *Amicus* could not determine the nature of the issue raising the section 6662(e) or (h) concern where the issue was not spelled out clearly in the case (often when the issue the court considers is procedural), *e.g.*, *Funk v. Commissioner*, 82 T.C.M. (CCH) 847 (2001). *Amicus* also omitted cases where the IRS conceded there was no penalty under section 6662(e) or (h) after first asserting it, *e.g.*, *Kraus v. Commissioner*, 85 T.C.M. 874 (2003); *Chin v. Commissioner*, 85 T.C.M. (CCH) 874 (2003); *Bradley v. MDC Credit Corp.*, 107 AFTR 2d 2011-1420 (D. S.D. 2011) (indemnity for tax liability; IRS apparently did not collect any penalties when case was resolved by stipulation). *Amicus* omitted them because the Commissioner's unwillingness to pursue the penalty issue might have reflected the Commissioner's conclusion that it was wrong to assert the penalty in the first place. *Amicus* also omitted section 482 cases, *e.g.*, *DHL Corp. v. Commissioner*, 76 T.C.M. 1122 (1998), *aff'd and rev'd*, 285 F.3d 1210 (9th Cir. 2012), because they are subject to a separate provision in section 6662(h). A number of cases cite section 6662(e) or section 6662(h) for purposes of analysis where the section was not an issue in the litigation before the court.

[25] Twenty-five Son-of-BOSS cases, eight foreign currency cases, and four CARDS cases do not involve overvaluations. On

(Continued on following page)

Instead, the inflated basis stems from a legal argument (for example, the proper treatment of contingent liabilities). "Value" plays no role in those cases.

In addition, the reported cases involve transactions that were promoted by major accounting firms or by other promoters. In only one case that does not involve an actual overvaluation did a taxpayer create inflated basis without the encouragement of promoters.[26] Under its current practice, the Commissioner apparently asserts penalties for inflated basis where there is no overvaluation only in structured transactions.

Given the overwhelming number of tax-shelter cases that were subject to section 6659 penalties, it seems plausible that, in the eyes of the Commissioner, the valuation misstatement penalty came to be viewed as another tax shelter penalty. But it isn't. There are penalty sections of the Code that are specifically intended to deal with tax shelter transactions, such as section 6662(d)(2)(C) (penalties not mitigated in certain circumstances when transaction is a tax shelter), section 6662(b)(6) (penalty in respect of underpayment attributable to disallowance of a tax benefit by reason of a transaction lacking economic

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the other hand, the seven Hoyt shelters do involve overvaluations. Less than half of the twenty-one other structured transactions *amicus* found involve actual overvaluations. The cases that don't involve overvaluations were all decided after 2004.

[26] The exception is *G.D. Parker, Inc.*, *supra* note 19.

substance), and section 6662A (imposition of accuracy-related penalty on understatements with respect to reportable transactions). The valuation misstatement penalties were not introduced into the Code to deal with tax shelters that do not involve overvaluation. They were part of an effort to control the Tax Court's case load.[27] From the reported cases from the 1980s, it appears that the IRS understood this limitation in the application of the valuation misstatement penalty. However, now it is using the valuation misstatement penalty as a surrogate for a "tax shelter" penalty that Congress has not authorized. The Court should reject the IRS's approach.

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[27] This is evident from the legislative history quoted above in Part III. *See also Drobny v. Commissioner*, 69 T.C.M. (CCH) 2600 (1995), which quotes from H.R. Rep. No. 98-861, 98th Cong., 2d Sess. 985-986 (June 23, 1984), 1984-3 C.B. (Vol. 2) 239-240, as follows (emphasis added):

> The conferees note that a number of the provisions of recent legislation have been designed, in whole or in part, to deal with the Tax Court backlog. Examples of these provisions are the increased damages assessable for instituting or maintaining Tax Court proceedings primarily for delay or that are frivolous or groundless (sec. 6673), the adjustment of interest rates (sec. 6621), *the valuation overstatement* and substantial understatement penalties (secs. 6659 and 6661), and the tax straddle rules (secs. 1092 and 1256).

CONCLUSION

A cursory reading of section 6662(e) and section 6662(h) might suggest that these "valuation misstatement" penalties apply to a wide range of transactions that have nothing to do with valuations. However, when standard rules of statutory interpretation are applied to these provisions, their scope is substantially narrowed. This narrower application is consistent with the legislative history of these penalty provisions and their actual application, with one notable exception: the IRS has recently applied these provisions to tax shelters that involve no issues of valuation. Indeed, the substantial majority of recent cases where the IRS has asserted the 40% penalty of section 6662(h) involve tax shelters with inflated basis and no overvaluation. The IRS does not have the authority to assert a valuation misstatement penalty in those cases.

If this understanding of the misstatement penalties is recognized, the penalty should not be applied in many of the cases in which it has been recently asserted. These cases are tax shelters without economic substance. These shelters inflate basis without reference to any valuation misstatement. Taxpayers have argued that, if their shelter deductions are disallowed because the transaction has no economic substance, they cannot be penalized under section 6662(h) because reducing the inflated basis was not necessary in order to disallow their deductions. If section 6662(h) is properly understood, the penalty does not apply in these situations in any event, and the

issue that was presented to the Supreme Court in this case disappears.

Respectfully submitted,

DAVID J. SHAKOW
Amicus Curiae and Counsel of Record
PROFESSOR OF LAW, EMERITUS
UNIVERSITY OF PENNSYLVANIA LAW SCHOOL
3501 Sansom Street
Philadelphia, PA 19104
dshakow@law.upenn.edu
(215) 898-7483

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